	<b>Barents Group</b> 1676 International Drive McLean VA 22102-4828	Tel: 703.747.3000 Tel: 1.866.FOR.KCIN Fax: 703.747.8750	<a href="http://www.kpmgconsulting.com">www.kpmgconsulting.com</a> <small>KPMG Consulting Inc. is an Independent Consulting Company</small>
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January 23, 2003

Mr. Lewis Tatem, Senior Economist  
Cognizant Technical Officer  
USAID Office of Market Transition  
Almaty, Kazakhstan

**SUBJECT: Financial Restructuring and Financial Sector Accounting Reform Technical Assistance to the National Bank of the Republic of Kazakhstan and the Central Bank of Uzbekistan**  
**Contract No.: OUT-PCE-I-803-99-00006-00**  
**Final Report**

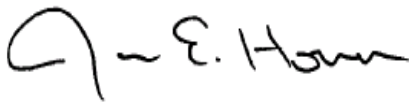
Dear Mr. Tatem:

Enclosed you will find the final report for the period of technical assistance to the National Bank of Kazakhstan and the Central Bank of Uzbekistan from March, 2000 to September, 2002. This report details our achievement of each of the benchmarks and tangible results associated with this project.

Please note, that KPMG Consulting has recently changed its corporate name to BearingPoint, Inc. We will soon contractually change our name on all USAID contracts. From that point forward, we will officially use the BearingPoint, Inc. name on all USAID contracts and projects.

Should you have any questions or would like to request further information, please contact me via telephone at 703-747-3248, or via email at [jhorner@bearingpoint.net](mailto:jhorner@bearingpoint.net).

Very truly yours,  
KPMG Consulting, LLC



James E. Horner  
Managing Director, Barents Group

cc: Chris Bartrop, USAID, Washington DC  
Resident Advisors: Stirewalt and Hawkins  
Project File

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## USAID CONTRACTOR INFORMATION

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The following individuals provided assistance during this Project.

*Washington, DC, Non-Resident Advisors:*  
 Jimmy Horner, Managing Director  
 Tina Mendelson, Advisor

*Temporary Advisors (Kazakhstan only):*  
 Mitchell Ashear, Deposit Insurance Fund Management  
 Daniel Callis, Training  
 David Cooke, Deposit Insurance Fund Management and Bank Liquidations  
 Gary Gegenheimer, Legal Issues  
 David Hawkins, Supervisory Process and Off-Site Analysis  
 Joel Hefty, Bank Reporting Issues and Training  
 Michael Newton, Deposit Insurance Fund Management and Bank Liquidation  
 Stanley Silverberg, Deposit Insurance Fund Management  
 Geary Vance, Training

*Temporary Advisors (Uzbekistan only):*  
 Raymond Mino, Accounting Advisor

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*Common Abbreviations Used Throughout this Report:*


ADB	Asian Development Bank
Barents	Barents Group of BearingPoint (formerly KPMG Consulting, Inc.)
BISD	Bank and Insurance Supervision Department
BSD	Bank Supervision Department
CBU	Central Bank of Uzbekistan
KDIF	Kazakhstan Deposit Insurance Fund
EIC	Examiner (Inspector) in Charge
FSVC	Financial Services Volunteer Corps
IAS	International Accounting Standards
IMF	International Monetary Fund
KDIF	Kazakhstan Deposit Insurance Fund
NBRK	National Bank of the Republic of Kazakhstan
NBFI	Non-Bank Financial Institutions
Project	Financial Restructuring and Financial Sector Accounting Reform in Kazakhstan and Uzbekistan
RA	Resident Advisor
TA	Temporary Advisor
USAID	United States Agency for International Development

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**KAZAKHSTAN - NATIONAL BANK OF KAZAKHSTAN**  
**Final Report – Banking Supervision Assistance**

Contractor: Barents Group, LLC  
Task Order: OUT-PCE-I-803-99-00006-00  
Country: Kazakhstan  
Title of Task Order: Financial Restructuring and Financial Sector Accounting Reform  
Reporting Period: 03/01/2000 to 09/30/2002  
USAID COTR: Tatem, Lewis  
USAID COTR Office: Almaty, Kazakhstan  
Strategic Objective: 1.3  
Intermediate Result: 1.3.2

Prepared by Bryan D. Stirewalt, Chief of Party and Resident Advisor  
James E. Horner, Managing Director  
Tina Mendelson, Advisor  
October 31, 2002

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## I. BACKGROUND


This report covers the progress of Barents Group assistance to the United States Agency for International Development (USAID) in relation to “Financial Restructuring and Financial Sector Accounting Reform.” The narrative discussion follows the scope of work requirements, and relates directly to the tangible results and benchmarks established for this project.

Since 1995, USAID has provided assistance to the Banking Supervision Department of the National Bank of the Republic of Kazakhstan (NBRK). The goal of this assistance has been to develop, modernize, and strengthen NBRK banking supervision processes. Technical assistance provided by USAID through Barents Group advisors is described in this report in a chronological fashion. The initial phase (Phase I) of technical assistance dates from March 2000 through March 31, 2001, Phase II from April 2001 through July 31, 2001, Phase III from August 2001 through December 31, 2001, Phase IV from January 2002 through March 31, 2002 and Phase V from April 2002 to August 30, 2002. The specific, approved scopes of work for each phase of this Project can be found within the narrative text of this report, Section III.

## II. KAZAKHSTAN – PROJECT SUCCESS STORIES

During this Project, our advisors have contributed to many significant accomplishments that will have direct consequences for the financial sector development in Kazakhstan. The following summarizes the most significant of those accomplishments.

- The President of Kazakhstan signed a new Banking Law on March 2, 2001. This new Banking Law included a highly controversial provision that authorized the NBRK to perform consolidated supervision of financial and industrial groups in Kazakhstan. Barents advisors provided considerable assistance with this effort, including presentations to the Kazakhstani Parliament, mass media, banker’s associations, and NBRK staff.
- A complete set of banking prudential norms were negotiated with commercial banks and with the Association of Financiers to be consistent with the changes in the banking law and consistent with modern practices for banking supervisors.
- A comprehensive set of recommendations were issued to improve risk management systems at commercial banks. Barents advisors were instrumental in drafting the basic risk management requirements for commercial banks from international standards.
- Several training courses were delivered, particularly focused on new forms of banking risk such as liquidity risk, interest rate risk and overall asset and liability management strategies. We believe these courses have also improved overall institutional knowledge of risk management, not only within the NBRK but also with the commercial banking sector.
- New laws on microfinance organizations and credit partnerships were drafted. Barents advisors provided legal and practical assistance to develop these laws, which removed much of the regulatory burden on microlending organizations and credit partnerships allowing less expensive credit to be provided to small- and medium-sized businesses in Kazakhstan.
- A deposit insurance scheme has been adopted and is operating consistently with many international best practices. Barents advisors have supplied considerable advice and research in this area and have worked closely with the Director of the KDIF throughout the existence of the KDIF.

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### III. SUMMARY OF PROJECT ACTIVITY

#### PHASE I – MARCH 2000 THROUGH MARCH 31, 2001

##### A. Assist the NBRK to develop a method of effective, consolidated supervision


Financial risks may emanate from entities that are directly regulated, such as banking, securities, or insurance, but may also emanate from any legal entity or person that is affiliated, through common control or significant influence, with a financial sector entity. The regulator must therefore have knowledge of the entire financial group. While the financial service regulator does not need to impose formal requirements on the activities of affiliated, non-financial companies, the regulators do need to know the risks that non-financial companies pose to banks, insurance companies, and securities firms that are regulated.

The supervision of financial conglomerates, or financial groups, is thus designed to address the entire group. In this light, the financial sector regulator needs to review the corporate governance standards of the financial group. This includes analyzing the ownership structure and the internal controls the financial group uses to manage its activities. The financial sector regulator needs to review and assess the financial conglomerate's controls on intra-group transactions and have continuing knowledge of aggregated large risk exposures within a financial group. By only analyzing one particular entity within the group, it is often not possible to know the actual risks of the group as a whole. The financial sector regulators also need to assess the adequacy of capital on a consolidated basis to prevent a single financial entity within a financial group from showing an adequate capital position by virtue of accounting gimmicks. Further, the financial sector regulator needs to review, understand and assess the financial group's internal risk management systems. Finally, financial sector regulators also need the authority to inspect the records of non-financial affiliates, although typically this authority is used only in rare cases demonstrating a clear need of increased scrutiny.<sup>1</sup>

In the event that problems are discovered in related companies that could adversely impact the bank, the supervisor needs to have the authority to require corrective action. Again, this authority should only be used in extreme cases, and ideally should be undertaken by, or in close cooperation with, other supervisory authorities. The most important risks that the financial sector regulators need to be concerned about are: contagion; group exposures to particular counterparties; transparency of legal and managerial structures, quality of management; and moral hazard.

During the initial weeks of the project, RA Stirewalt met with several members of the BISD and a visiting delegation from the IMF to discuss current methods and regulations associated with consolidated supervision. The IMF team was in Kazakhstan evaluating compliance with the Core Principles of Banking Supervision as outlined by the Basle Committee on Banking Supervision. From early meetings with BSD personnel and the IMF, the BISD appeared to be confusing the concept of consolidated *accounting* with consolidated *supervision*. This is a significant issue as consolidated accounting can actually make consolidated supervision more difficult, rather than vice-versa. The NBRK received a draft report from the IMF concerning compliance with the Core Principles of Banking Supervision that was critical of the NBRK's efforts to achieve consolidated supervision. Following receipt of the IMF report, RA Stirewalt met with members of the BISD to discuss current methods and regulations associated with consolidated supervision, and prepared an outline of changes necessary to achieve effective, consolidated supervision including changes to internal committee structures, changes to the Banking Law, changes and additions to Prudential Normatives, and several key definitions of terms.

<sup>1</sup> See generally Ronald McDonald, Consolidated Supervision of Banks, Handbooks in Central Banking No. 15 (Bank of England, 1998) [hereinafter Consolidated Supervision of Banks] at 13.

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RA Stirewalt and TA Gegenheimer, who assisted with many of the legal aspects of banking supervision, prepared a comprehensive package of information and research for the NBRK on consolidated supervision. This package contained the necessary first steps to achieve effective consolidated supervision. Within this context, RA Stirewalt delivered a one-day course to BISD staff relative to the topic of consolidated supervision, including the changes that are necessary for the BISD. Barents also prepared and delivered to the NBRK relevant documents on this topic, including:


- a review of the NBRK's proposed changes to the Banking Law with suggestions for further amendments;
- a set of additional recommendations for amendments to the Banking Law, including bank liquidation, money laundering and legal protection for inspectors performing their jobs in good faith;
- an outline of international terminology related to the concept of consolidated supervision; and,
- a comprehensive legal analysis of consolidated supervision mechanisms and regulatory structure in the United States and in Germany.

Following delivery of this information, RA Stirewalt met with the Chairman of the NBRK (Mr. Marchenko) to discuss the recommendations to the Banking Law and the political strategies for achieving success. Mr. Marchenko was receptive of the quality of work performed by Barents Group advisors. However, given the current track of the Banking Law in the legislative schedule in Kazakhstan, the Chairman was uncertain if all recommendations could be inserted into the Banking Law during this legislative session. The Chairman requested assistance of Barents advisors to explain consolidated supervision to the Kazakhstani Parliament and to the banking community. Further, Mr. Marchenko requested RA Stirewalt to draft a letter to the President of Kazakhstan outlining the need for consolidated supervision. In general, domestic banks were against this concept and were lobbying the President against consolidated supervision.

RA Stirewalt met on several occasions with Mr. Daulet Sembaev, Chairman of the Association of Financiers<sup>2</sup>, his staff, selected senior attorneys from Kazakhstani banks and several members of the NBRK Legal Departments. These meetings were held to provide an overview of the suggested amendments to the Banking Law regarding consolidated supervision and attempt to obtain an understanding and buy-in for the banking law amendments from the industry. Mr. Sembaev appreciated the overview and voiced his general support for the amendments and requested RA Stirewalt to present a more detailed review of international standards regarding consolidated supervision and how these standards specifically related to Kazakhstan. RA Stirewalt provided a five-hour overview of international banking supervision and accounting standards regarding consolidated supervision to an audience selected by Mr. Sembaev. The audience represented the top ten domestic banks in Kazakhstan. Following this meeting, Mr. Sembaev endorsed the conceptual amendments to the Banking Law. Like Mr. Marchenko, Mr. Sembaev also noted the need for technical assistance to explain these suggested amendments to Members of Parliament. Further adding support to this issue, Kazakhstan President Narzarbaev expressed his support of consolidated supervision principles in local media and in his semi-annual discussions with National Bank Chairman Marchenko.

TA Gegenheimer and RA Stirewalt began working closely with the BISD and the NBRK Legal Department, in addition to the leading financial lobby group in Kazakhstan to finalize the amendments to the Banking Law for its submission to Parliament. The Banking Law was submitted to Parliament during the second week of September, 2000. On September 21, at the request of the Governor of the NBRK, TA Gegenheimer and RA Stirewalt presented Banking Law Aendments and international standards and

<sup>2</sup> Mr. Sembaev is a former Chairman of the NBRK, a former Member of Parliament, and Charmain of the Kazakhstan Association of Financiers which is the leading bank lobbyist group in Kazakhstan.

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practices concerning consolidated supervision to Kazakhstan's Parliament in the capital city of Astana. To a more limited degree, advisors also discussed international standards and practices regarding bank liquidations. The presentation was followed with letters written through the NBRK to Parliament offering clarification on complex issues.

At the request of the NBRK Chairman, RA Stirewalt delivered a 90-minute press conference, explaining international standards and practices with regard to consolidated supervision. Both television and print media covered this press conference and this has resulted in considerable publicity.

Collecting proper and timely information, without causing an unnecessary regulatory burden to the banks, is extremely important to the implementation of consolidated supervision. In this context, TA Joel Hefty assisted the BISD develop a financial reporting format for consolidated supervision (i.e. how to properly collect data from bank affiliates and significant controlling owners). TA Hefty met with several commercial banks and various departments of the NBRK to determine user needs of information. Accordingly, he provided a comprehensive set of forms and instructions for the NBRK to use in collecting information from the aforementioned entities. TA Hefty also developed a comprehensive set of licensing guidelines and operating instructions for the purpose of consolidated supervision. TA Hefty delivered this package to the BISD and held discussion sessions on their usage with the analysts assigned responsibility for complex banking groups.


At the end of 2000, the NBRK Management Board formally approved the concept of merging the banking supervision department with the insurance supervision department. RA Stirewalt met with USAID advisors to the insurance regulator to discuss a working plan to address this consolidation, as well as consideration of an independent agency for financial regulation in Kazakhstan. RA Stirewalt provided the Chairman of the NBRK with organizational structures of the United Kingdom's Financial Services Authority and the Hungarian Financial Services Authority as well as a template that outlines the corporate governance structures of each these supervisory bodies. RA Stirewalt and another USAID advisor (Mr. Paul Pieper, Pragma Corporation) jointly drafted a letter to USAID/CAR outlining the risks and salient points of information regarding the merger of financial regulators into one entity.

On March 2, 2001, the President of the Republic of Kazakhstan signed the amended "Law on Banks and Banking Activity", inclusive of the amendments that enable the NBRK to conduct consolidated supervision. These amendments to the Banking Law in Kazakhstan are a major step forward for banking supervision. Kazakhstan is clearly the first country in Central Asia to address this issue, and ranks amongst the elite transition economies in this respect. The Banking Law is already having an effect in the banking industry as several large banks are changing ownership structures, hopefully to rid the organizations of owners who prefer not to disclose themselves to the NBRK or the general public. Anecdotally, the trading volumes in bank shares on the Kazakhstan Stock Exchange has increased significantly since the Lower House of Parliament passed the amendments to the Banking Law on consolidated supervision. By properly "shining a light" on insider relationships and related-party business transactions, more funds should be available for lending to the non-affiliated business sector in the Kazakhstan economy and clearly the banking industry has made a large stride toward increasing transparency.

Once the amendments to Banking Law were passed, RA Stirewalt and other Barents advisors focused their assistance on supporting the NBRK to properly exercise effective consolidated supervision in the banking industry and formalizing cooperation with other financial regulators to minimize regulatory burden and increase supervisory efficiency.

**B. Assist the BISD with organizational structure and process issues, including an assessment of human resource practices**



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Early in the Project, RA Stirewalt reviewed a draft organizational chart for a revised structure of the BISD. RA Stirewalt discussed the organizational chart with the Director of the BISD, including presentation of organizational charts of the United States Federal Reserve Bank and Federal Deposit Insurance Corporation, and Poland's General Inspectorate of Banking Supervision. Following this discussion, RA Stirewalt met with the Director of BISD to discuss an outline for a "supervisory cycle" for bank and non-bank inspections and off-site monitoring. The Director was considering a reduction in staff because certain analysis functions were redundant and not fully productive. RA Stirewalt suggested a redirection of human resources toward on-site supervision and consolidated supervision of complex financial groups, rather than a reduction in the overall workforce. For this purpose, RA Stirewalt developed and delivered a prospective outline of the banking industry in Kazakhstan with licensing and regulatory requirements for institutions within each of four separate categories. Included in this outline is a recommendation for the "supervisory cycle" of each type of institution from most risk to least risk. This supervisory cycle definition is to be used as the basis for determining staff size of the BISD and inspections scheduling. The Director incorporated this advice into the planned organizational changes.

Further, TA Geary Vance met with the National Bank's Human Resource and Training Department (HRTD) Department to discuss methods of modern-day human resource management on several occasions during his visits to Kazakhstan. The HRTD officials were pleased with the offer of assistance and receptive to this discussion. The HRTD has since shared several documents on human resource management for our review. TA Vance reviewed several processes and forms that he has used in the human resource area of a commercial bank, including a sample of a human resource manual of a commercial bank in the United States. The HRTD was receptive to this information and discussed various details in length.

The HRTD also provided a copy of their departmental strategic plan for review and commentary in August, 2000. TA Vance reviewed this document and discussed it with the HRTD. The NBRK was most concerned about developing a corporate culture and in methods to improve employee turnover, particularly in banking supervision. TA Vance discussed several monetary and non-monetary methods of how to improve culture, morale, and reducing employee turnover. TA Vance also met with the Human Resource Department of the nation's largest bank, Halyk Savings Bank, regarding similar issues. Halyk Savings Bank, at that time, remained majority state-owned and wished to improve its image with the public as well as develop its staff skills.

### **C. Assist the BISD with on-site inspections of commercial banks**

Early in the Project, RA Stirewalt met with the senior-most person in the BISD related to on-site supervision of commercial banks to offer assistance. The proper method of assistance was discussed and debated between full weeks of assistance at bank inspections, or shorter periods of technical assistance at several banks.

This area of bank supervision deserves considerably more attention than has been devoted under this Task Order. The inspection process remains compliance-driven rather than prudential-driven. Inspectors complete a voluminous report of inspection that is not conclusion-oriented and provides neither the bank nor the NBRK with any material new information. Additionally, the inspectors only look at market risk components as they related to compliance with a prudential normative. Since no prudential normative exists for interest rate risk, this area is ignored completely. Compliance with normative requirements is not, and should not be the only indicator of management adequacy. Given a limited number of on-site inspectors at the NBRK, RA Stirewalt explored more involvement of the external audit industry with respect to risk assessment. RA Stirewalt along with TA Hefty also explored methods of streamlining bank financial reporting, which would allow more off-site analysts to assist with on-site inspections. From a

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practical standpoint on market risk issues, the NBRK should reconsider the prudential normatives in the areas of market risks and focus more attention on prudential guidance and verification of policies and processes through the external audit industry.

In this summary of our on-site inspection assistance from March 2000 - March 2001, we cannot provide details of the inspections and the names of the banks due for reasons of confidentiality. In March 2000, RA Stirewalt assisted the inspection team with conclusions and review of the inspection report. Several recommendations were made to make the inspection report a more useful document to the NBRK and for the commercial bank that is the subject of the inspection. In June 2000, RA Stirewalt assisted with an on-site inspection of a large bank. RA Stirewalt assisted the inspectors with their evaluation of the bank's earnings performance and with evaluation of market risk areas such as foreign exchange risk, interest rate risk and liquidity risk. RA Stirewalt also evaluated the on-site inspection process as a whole and discussed methods of improvement to the BISD. RA Stirewalt assisted with an on-site inspection of a foreign bank subsidiary during October, 2000. RA Stirewalt assisted the inspectors with their analysis of credit risk, liquidity risk, and foreign exchange risk including complex products such as foreign exchange forward contracts. RA Stirewalt provided ad-hoc assistance with an inspection of a large bank in January, 2001. RA Stirewalt did not attend the inspection, yet worked with the inspectors on several issues in the NBRK offices, such as valuation and accounting of a large, insider-related commercial real estate venture of the subject bank.


The NBRK also requested guidance on how best to deal with operational risk related to information technology. At that time, RA Stirewalt recommended targeted and highly specialized inspections to be done in cooperation with the NBRK's Information Technology Department. During March 2001, RA Stirewalt assisted the NBRK's Information Technology Department on basic areas to address in an information technology inspection and a proper rating system for these inspections.

RA Stirewalt provided the BISD with a methodology for evaluating market risks in commercial banks. The evaluation criteria focused on management quality, management information systems, and the level of market risks the bank has assumed. However, as these components could not be reduced to a numerical equation, the BISD was hesitant to adopt this standard in their CAMEL matrix. The current CAMEL matrix is comprised of purely objective measures of bank financial performance, and does not allow for management capabilities to influence ratings to any material degree.

#### **D. Assist the BISD to develop a formal, consistent policy guidebook for problem bank management**

RA Stirewalt delivered a Problem Bank Guidebook containing a sample enforcement policy for the BISD, a sample policy for issuance of various degrees of civil money penalties against persons who violated the Banking Law or otherwise expose a bank to excessive risk, and many examples of prudential enforcement actions that were used in other countries. This guidebook also contained a draft regulation on capital-based enforcement actions that are being discussed as part of the new amendments to the Basle Committee's Capital Accord. The most problematic issue with the Kazakh system of problem bank management was its heavy focus on relatively arbitrary punitive damages with no regard for rehabilitative measures. This guidebook was delivered to the BISD management on October 12.

RA Stirewalt used this material to assist the BISD with drafting a prudential based enforcement action against a large domestic bank that was in non-compliance with a prudential normative requirement. The BISD has not actively used its enforcement authority granted in the Banking Law, yet a problem bank enforcement mechanism is critical to effective banking supervision. This exercise was an initial attempt to draft a formal enforcement action against a bank. This was also an area of criticism from the IMF Core Principles Assessment.

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TA Gegenheimer drafted and delivered several recommendations to the Banking Law on the area of enforcement, with particular emphasis on the liquidation process. TA Gegenheimer's recommendations were delivered on June 29, 2000. RA Stirewalt discussed capital-driven enforcement actions with Deputy Governor Zhangel'din as an additional, somewhat objective, enforcement measure. A capital-driven enforcement policy was then included in a Problem Bank Supervision Guidebook for the BISD. The guidebook is designed to be a pro-active tool, not a re-active tool that is used in the liquidation process. The intention was to make the BISD more pro-active to stop banks from becoming problems rather than only dealing with banks once they are a serious problem.


RA Stirewalt also assisted the BISD with another enforcement issue involving a large commercial bank. RA Stirewalt worked closely with two divisions of the BISD to resolve the lending limit issue. This situation was made increasingly complex as the lending limit violation was difficult to calculate and the NBRK Management Board had prior knowledge and gave consent to the loan being made, before funds were initially advanced. RA Stirewalt provided assistance to members of the BISD and met with the bank in question in an attempt to resolve this politically volatile situation in an amicable manner. RA Stirewalt also delivered a recommendation concerning lending limit excessions for commercial banks. In summary, a bank requested a lending limit excession to accommodate its customers. RA Stirewalt recommended against granting any special exceptions to existing rules, but did offer ways to liberalize existing rules without sacrificing prudential standards.

**E. Provide ongoing training to the BISD based on their indicated training needs, offering a focus on advanced bank supervision topics, such as market risks and trade finance**

RA Stirewalt met, on several occasions, with the HRTD of the NBRK to discuss training initiatives in the near and long term. The NBRK admitted that the formal accreditation program, developed in 1996, had been discontinued in 1998/9 for three reasons: the economic crisis, the high degree of turnover in supervision activities, and the lack of qualified instructors. The HRTD and the BISD emphasized the need for training in more advanced topics such as market risks and with issues related to consistency with the Basle Core Principles. In addition, all courses were open to commercial bankers to improve overall understanding of risk management in the banking system.

The course that most closely meets the needs of the NBRK and the banking community is entitled "BankExec – International". The American Bankers Association has developed this case study oriented course. The course highlights market risks (foreign exchange risk, interest rate risk, and price risk) and includes balance sheet complexities that banks in Kazakhstan are only beginning to experience. Course participants are divided into teams of four to six people, selected in a random manner to create a more realistic experience. The teams then manage a fictitious commercial bank over a simulated two-year period of time, or eight quarters. Each quarter, the teams must decide how to attract money to their bank through deposits, through borrowings, or through issuing additional shares of common stock. Following this step, the team members must decide how to invest this money in the most profitable manner to increase their bank's stock price, without causing excessive risk to the quality of assets for the bank. The BankExec training course provides economic statistics and correlates each team's activity to calculate each of the bank's stock prices. Additionally, a simulated central bank sets regulations for certain activities of the banks and punishes those teams who violate the central bank's rules. At the end of the eight quarters of bank operations, the team with the highest stock price wins.

TA Vance and RA Stirewalt presented a 90-minute lecture each morning on topics selected by the course participants, and then the students began the case study decisions. The case study and team interaction formed the majority of the course time. Through this course, students achieved a higher level of appreciation and understanding for the complexities of managing bank liquidity, interest rate risk, and

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foreign exchange risk. Students also learned the dangers of aggressive growth through declining quality of assets. Interactive formats for learning accompanied by focused lectures have proven to be a more valuable learning experience than lectures alone. Additionally, participants learned to work in a team environment to make decisions.

TA Vance delivered the “BankExec – International” course on four occasions in this phase of our assistance. The course was delivered in April 2000, July 2000, October 2000, and February 2001 to a total of 90 participants, most of who were commercial bankers.

The following illustrates other training initiatives of this Project:

- In May 2000, RA Stirewalt delivered a four-hour lecture on Problem Loan Identification and Management to a group of commercial bankers. This lecture was delivered at the request of a local training center (“SANA”) in Almaty. Class participants were commercial bankers from four domestic banks. Positive comments were received from the participants and each expressed a desire for additional training of this sort.
- In June 2000, RA Stirewalt delivered two, half-day lectures on the topics of international standards for internal controls and audit activities, and on prudential norms. The presentations were to a group of external auditors in the process of obtaining a certification to perform bank audits in Kazakhstan.
- RA Stirewalt delivered one-day lectures on September 27 and 28, 2000 on the topic of corporate governance, internal controls and internal audit. RA Stirewalt specifically discussed and provided translated copies of three Basle Committee documents in this training session. Fifteen persons attended, representing eight commercial banks. The lecture on September 28 was given for the internal audit staff of a large commercial bank. A total of sixteen persons attended this lecture.
- RA Stirewalt delivered a one-day lecture in October 2000 to a group of twelve commercial bank internal auditors on the topics of corporate governance, internal controls and internal audit. RA Stirewalt discussed and provided translated copies of three Basle Committee documents in this training session, and delivered a further discussion of the internal control weaknesses that caused the failure of the Barings Bank (United Kingdom).
- In February 2001, TA Hefty delivered a four-day course on bank financial analysis for employees of various departments of the NBRK. Twelve participants attended this course, most of who were from the BISD. The course was mostly lecture oriented, with case studies to illustrate analysis skills.
- In February 2001, RA Stirewalt delivered a three-hour presentation on international standards relating to internal controls and internal audit of commercial banks at the invitation of an external, banker-training center in Almaty. This lecture was a part of a two-week course regarding legal aspects of banking operations. Fifteen participants attended the lecture, representing approximately 10 commercial banks.

**F. Assist the NBRK with developing an appropriate organizational structure, regulation and management of their deposit insurance system**

The NBRK adopted a deposit insurance program in late 1999 that became effective in February of 2000. The primary motivation for this program was the devaluation of the domestic currency (Kazakh Tenge) and the weakening confidence in the banking sector by the general public. The devaluation is explained by the Asian financial crisis that started with the devaluation of the Thailand Baht in July of 1997. This devaluation then translated into a global financial crisis for almost all developing economies. Following the effects of the Russian government debt default in August of 1998, the NBRK could no longer support the local currency and was forced to devalue the currency in March of 1999 by allowing it to freely float. The Kazakh Tenge initially devalued by nearly 100%. Offering deposit insurance was seen as a measure

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to bring stability to the banking sector, without a significant, immediate cash outlay by the Kazakhstan government.


The NBRK believed the problems in the banking sector were temporary, in the case of Kazakhstan, and wanted a mechanism for restoring banking sector confidence. Prior to this decision, the NBRK listened closely to various criticisms and cautions regarding their proposed deposit insurance program. However, in the opinion of the NBRK, early adoption of deposit insurance on a limited scope<sup>3</sup> was better for the people of Kazakhstan than postponing this decision further. Many external parties offered criticism and caution yet very few external parties offered specific advice, benchmarks or firm targets.

In general, experts commonly advised the NBRK that the best time to start a deposit insurance program is when the banking system has been cleaned of any immediate systemic risk and the majority of banks (at least 75-80% of the total asset base) are in stable condition. In other words, once a country can prove it does not need deposit insurance is the best time to start such a program. Although this statement is a bit facetious, it holds basic truth. A country does not want to start an insurance system, with government liability, when the risk of imminent payoff is almost certain. Creating a deposit insurance system prematurely leaves governments with only two real outcomes: 1) a massive drain on the national budget to pay liabilities, or 2) creation of a deposit insurance system that builds no confidence because depositor protection remains equally as uncertain as the banking system was before deposit insurance.

Every country in the former Soviet Union and Eastern Europe has a form of deposit insurance. The primary factor that separates countries from one another in this area is whether the deposit insurance is explicit or implicit. In other words, is the insurance coverage transparent to the general public (explicit) or merely assumed by the general public (implicit)? Most countries in this region of the world have a former state savings bank (Russia's Sberbank, Poland's PKO S.A., and Kazakhstan's Halyk Savings Bank) that maintains the largest share of household deposits. Customers have maintained their accounts at the state savings bank for years, and are reluctant to move their banking relationship to an institution that is not well known to them. Banking customers generally assume that the former state savings banks are government guaranteed, whether true or not. The former state savings bank in Kazakhstan is fully privatized, yet many people (particularly pensioners) falsely believe the bank is government guaranteed. As such, before deposit insurance was initiated, these banks were assumed to have either an implicit guarantee from the government through existing laws or an implicit guarantee because the government was bank's controlling shareholder. Therefore, a transparent and explicit and more transparent insurance coverage amount might actually decrease the government's implied liability from "all household deposits" to a limited coverage through deposit insurance. This could be a strong argument for earlier adoption of a deposit insurance program.

Management of the KDIF was one of the most critical needs during this phase of USAID technical assistance. We have tried consistently in our advice to the NBRK to separate "front office" issues with deposit insurance from "back office" issues. Front office issues (such as deposit insurance coverage) are items that affect the relationship between the deposit insurance fund and the insured depositors. The governing rule behind this relationship is simplicity, in addition to transparency. Back office issues (such as insurance premiums and the target balance of the fund) are items that affect the relationship between the deposit insurance fund and the participating banks. These items can be more complex, although also transparent, as the banks are sophisticated market participants. Also, we have continuously advised the NBRK to think about the bank liquidation process as items in deposit insurance become more complicated.

<sup>3</sup> Initially, deposit insurance was offered to only 17 banks and only covered time deposits of natural persons. Deposits of legal persons and any type of transaction or savings accounts were excluded from coverage.

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RA Stirewalt met with the Director of the KDIF in March 2000, and later drafted two documents related to the theory and practice of risk-based insurance premium assessments. Each of the documents was consistent with previous advice of USAID consultants, encouraging simplicity of KDIF management in the early stages of development. RA Stirewalt did deviate from prior advice to propose a compromise between flat-rate assessments and a simplistic form of risk-based assessments, as required by the KDIF Law. It is easier to build a simple process for risk-based assessments than to amend the law.

TA Sherwin Koopmans arrived in Kazakhstan for a three-week visit assisting the KDIF. Mr. Koopmans met with the Director of the KDIF each day of his three-week visit. The Director delivered prepared questions each morning and TA Koopmans prepared written answers each afternoon and discussed those answers and issues the next day. This proved to be a highly interactive visit. TA Koopmans and RA Stirewalt also met with two banks that were participants in the KDIF to obtain their views and comments on the overall operation of the KDIF. The primary issues discussed during TA Koopmans' visit were: the KDIF Law, the staffing and organizational structure (current and future) of the KDIF and its supervisory board, a target balance for the KDIF, assessing insurance premiums for KDIF participants, the bank liquidation process, and various methods of streamlining depositor payoff after a bank is closed without damaging the banking system. Considerable attention was devoted to contingency planning for the worst-case scenario of a "top-three" bank failure.

RA Stirewalt continued to meet with, and do research for, the Director of the KDIF on several occasions following the departure of TA Koopmans, and continued to focus on the overarching principles of simplicity and ease of explanation. This area of technical assistance was absorbing considerably more time and attention than thought at the beginning of this task order. In September 2000, USAID notified RA Stirewalt of an allocation of funds specifically for the deposit insurance area.

Accordingly, TA Stanley Silverberg traveled to Kazakhstan in December 2000 for a two-week period to assist the management of the KDIF further on issues specified related to "insurance" rather than other issues associated with liquidations. Mr. Silverberg and RA Stirewalt met with the management of the KDIF and the NBRK on several occasions during this two-week period to discuss various aspects of the deposit insurance program in Kazakhstan. Items discussed during Mr. Silverberg's visit included the following:


- risk-based assessments for deposit insurance premiums and the target balance of the deposit insurance fund;
- deposit insurance coverage, composition of the KDIF management board;
- entry to and exit from the deposit insurance system;
- bank liquidations and depositor payout mechanisms; and,
- foreign currency risk for the deposit insurance investment fund.

Written recommendations were delivered to the NBRK and KDIF management teams regarding each of these areas. RA Stirewalt provided further written guidance and clarification to Mr. Silverberg's recommendations. In addition, RA Stirewalt attended two supervisory board meetings of the KDIF and provided several recommendations to the KDIF management as a result of these meetings. RA Stirewalt particularly focused attention on strengthening the approval process for new members to the deposit insurance fund.

In March 2001, TA Michael Newton began five-months of technical assistance to the KDIF and the NBRK Bank Liquidation Department. As the changes in the Banking Law (discussed above under Consolidated Supervision section) also greatly affected the operations of the Bank Liquidations Department of the NBRK, RA Newton's arrival was timely. RA Newton was able to immediately begin advisory assistance in the bank liquidation area with the drafting process for implementing regulations from the amendments to

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the Banking Law. RA Newton has also provided advice relative to changes in the deposit insurance regulation through participation on a deposit insurance working group.

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#### **G. Assist the NBRK with general advice**

Fiduciary activity. RA Stirewalt reviewed a draft regulation related to fiduciary activity of commercial banks and offered a significantly revised version of the regulation for BISD usage. RA Stirewalt also delivered written guidance for the BISD to use in reviewing fiduciary activities of banks and ascertaining the risk of these fiduciary activities.


Credit partnerships. RA Stirewalt reviewed certain administrative procedures for credit partnerships. Credit partnerships are a hybrid entity between commercial banks and credit unions and are not functioning at the level anticipated when they were originally formed. In short, the partners of credit partnership must individually register with the Ministries of Finance and Justice on the partnership's charter documents. If the partnership wishes to add a new partner, it must re-register prior to obtaining NBRK approval for the new partner. This appears to be an unnecessary administrative burden. RA Stirewalt discussed possible methods of procedural change that would streamline this process, including registering a range of partners for the general partnership charter and the individual partners with the NBRK only. RA Stirewalt delivered a document to enhance small business lending, and small bank licensing in Kazakhstan. BISD and NBRK management members were receptive to these recommendations. Related to this topic, RA Stirewalt provided an explanatory document of credit union operations in the United States, as compared with credit partnerships in Kazakhstan. RA Stirewalt continues to encourage the NBRK and BISD to support small business lending initiatives.

Electronic/ Internet banking. RA Stirewalt drafted and delivered an overview of electronic banking, with particular emphasis on Internet banking, to the NBRK. Governor Marchenko and Deputy Governor Zhangel'din requested this review. Several banks in Kazakhstan have begun offering limited levels of Internet banking services to clients and many other banks are preparing to offer this service in the near future. RA Stirewalt assisted the BISD with development of a regulation on Internet banking activity. Very few, if any, developed or developing countries around the globe are strictly regulating this activity. RA Stirewalt recommended that the NBRK provide an approval for "transactional" Internet banking activity and require certain risk management systems and security devices to be in place prior to initiation of this service. The draft regulation includes increased burden on the external audit industry rather than the BISD. Additionally, RA Stirewalt is assisting the NBRK with creating a team of experts, primary from the Payment Systems Department, to perform the inspections of Internet banking facilities.

Subordinated debt issuance. RA Stirewalt was requested to review a prospectus for a subordinated debt issuance of a large, domestic bank. This review was to determine if the subordinated debt instrument qualified as capital for the bank for banking supervision purposes. RA Stirewalt highlighted several critical issues with the subordinated debt prospectus and worked with the NBRK and the issuing bank to cure these problems. RA Stirewalt delivered a letter to the BISD and Accounting Departments of the NBRK discussing the regulatory and accounting issues surrounding subordinated debt. RA Stirewalt also presented an overview of subordinated debt in general to these groups to develop a better understanding of the debt instrument. Related to this topic, RA Stirewalt provided a letter to the NBRK Accounting Department answering certain specific questions posed by the issuer of this subordinated debt instrument.

Bank accounting. RA Stirewalt delivered advice to the NBRK Accounting Department on various issues relative to International Accounting Standards (IAS). Specifically, the issues discussed were related to international practices for various off-balance sheet commitments, such as stand-by letters of credit, bid bonds, performance bonds and certain underwriting commitments. Additionally, the Accounting Department requested advice on the concept of a "business unit" and the accounting practices for disposal of a business unit as opposed to a subsidiary. Due to the ad-hoc nature of these requests, each of these items was discussed informally with no written correspondence.



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RA Stirewalt provided accounting advice on consolidation of bank subsidiaries into a commercial bank's balance sheet. International Accounting Standards require full consolidation of subsidiaries. However, this presents a significant problem with consolidation of insurance subsidiaries of banks and simultaneous protection of the integrity and readability of the bank's financial statements. Other authorized investments by a bank are much closer to traditional banking activity than insurance companies and may not present this problem. RA Stirewalt recommended the equity method of consolidation for insurance companies rather than the line-by-line method.

Cross-border regulation. RA Stirewalt reviewed and provided comments to a draft "Statement of Cooperation" between the NBRK and the State Bank of Pakistan on banking supervision issues. RA Stirewalt developed a sample template for future information sharing agreements with other banking regulators. The Basle Core Principles for Effective Banking Supervision requires a method of information sharing with cross-border regulators.

Basle Banking Supervision Standards. RA Stirewalt delivered a summary of the new Basle Committee on Banking Supervision Capital Adequacy Accord ("New Accord") to members of the senior management of the NBRK. The upcoming changes in the New Accord are extensive and will provide a significant challenge for the BSD to successfully implement.

Merger Activity. RA Stirewalt provided written advice regarding the potential merger of the two largest banks in Kazakhstan. This merger could have detrimental effects on competition in the banking system and negative effects on the fledgling deposit insurance system. RA Stirewalt advised against approval of the merger, yet offered several supervisory recommendations regarding the combined entity, in the case the merger is approved.


Risk Management. The NBRK's management board requested advisory assistance with drafting a regulation concerning risk management in banking organizations. The Basle Committee has indirectly advised against regulating risk management, as a whole, with preference toward providing individual risk management guidelines for various banking risks. RA Stirewalt delivered a comprehensive draft regulation, relating to corporate governance, risk management, internal controls, capital adequacy assessments and transparency of banking operations. The BSD expressed a desire to deal with internal controls, capital adequacy assessments and transparency as separate issues. However, the concepts of corporate governance and risk management were accepted. The corporate governance and risk management regulation addressed the nine basic areas of banking risk: credit risk, interest rate risk, liquidity risk, price risk, foreign exchange risk, country risk, operational risk, legal risk and reputational risk. RA Stirewalt has recommended that the BSD form its accreditation process around these nine risk components.

Inter-bank market insurance fund. The NBRK initiated discussion of an insurance fund for the inter-bank market. The NBRK felt that the inter-bank market was not developing, and only served as an overnight investment vehicle. The insurance fund would boost confidence in the inter-bank market and lengthen maturities in the inter-bank market. RA Stirewalt worked with various individuals from the Monetary Policy and Statistics Department, providing them with statistics and research from other countries, to eventually curtail this idea. An insurance fund for inter-bank markets would bring increased government intervention to a functioning private marketplace.

Capital adequacy. RA Stirewalt provided guidance to the BSD relative to the capital size for existing and new banking institutions in Kazakhstan. The NBRK management board wished to raise the capital required to open a second tier bank from 1 billion Kazakh Tenge to 2 billion Tenge. RA Stirewalt recommended leaving the amount of capital unchanged and focusing more attention on capital adequacy

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as the proper gage of bank safety. In the end, the NBRK Management Board voted to increase the initial capital to 2 billion Tenge.

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## **PHASE II – APRIL 2001 THROUGH JULY 31, 2001**

### **A. Continue to provide assistance to the NBRK in the area of consolidated supervision**

RA Stirewalt worked with the BISD Methodology Division on the issue of capital adequacy for heterogeneous financial conglomerates. The Joint Forum on Supervision of Financial Conglomerates has provided guidance in this area. The Joint Forum is a group, closely linked to the Bank for International Settlements, which is comprised of supervisors of banking, insurance, and securities industries. The BISD developed a regulation to address the Joint Forum guidance. While the BISD's initial draft regulation meets the goal of simplicity, it fell far short of meeting the spirit and intent of the Joint Forum's guidance.

RA Stirewalt worked closely with the BISD Methodology Division with the drafting of four regulations as well as discussing these regulations with members of the Association of Financiers. The BISD held several rounds of often contentious and difficult discussions with this lobbyist group during May 2001. RA Stirewalt provided support to the group by explaining various international standards and practices in each of the areas being discussed. The regulations in question were:


- Prudential norms for banking groups, including minimum capital, capital adequacy, and large exposures;
- Approval requirements for large participants and bank holding companies;
- Reporting requirements for large participants and bank holding companies; and
- Inspection procedures for banking group affiliates.

Due to the large differences of opinion between the banking community and the BSD on these topics, RA Stirewalt met with Chairman Marchenko and Deputy Governor Zhangel'din to discuss political strategy for future discussions with the banking industry. As a result of these meetings, RA Stirewalt continued to act as a bridge between international standards and experience and emerging market reality and capabilities relative to consolidated supervision.

Following several rounds of discussions, the Association of Financiers agreed to the language within three of four regulations. The final regulation, discussing prudential norms requirements for banking groups in the areas of minimum capital, capital adequacy and large exposures remained unresolved. The major disagreements with the minimum capital requirements for banking groups centered on weak accounting knowledge by the bank supervision department. RA Stirewalt and the Association of Financiers have explained these discrepancies in detail, yet the author of the normative continually chose a separate direction. The banking industry wished to delay full implementation of this regulation until April 1, 2003 while the NBRK wanted to implement this regulation on October 1, 2001.

In July 2001, the NBRK requested RA Stirewalt's attention to be turned to the issue of creating a unified financial sector regulator in Kazakhstan. Barents and other USAID advisors working with the Financial Protection Initiative have provided limited advice in this area throughout the last year. In general, USAID advisors have suggested creating a unified regulator within the NBRK for a period of three to five years. The NBRK generally agreed with the time period and the advisors' overall concept of a unified regulator. After the three to five year period, the government could create a separate and independent regulatory body for all financial sector entities, similar to the Financial Services Authority in the United Kingdom. In late June, the government (including an endorsement from President Nazarbaev) suggested that the unified regulator must be completely independent from the NBRK on or before January 1, 2002.

Barents and other financial sector advisors believed that six months was far too short of a time frame to transfer the respective staffs of these financial regulators to an independent agency. RA Stirewalt

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provided several talking points to the Chairman of the NBRK on this issue, cautioning the NBRK on the unreasonableness of this timeframe. Chairman Marchenko then convinced the government to allow at least 12 to 18 months before moving ahead with an independent body.

On July 12, 2001, the President of Kazakhstan issued a Decree that abolished the National Securities Commission as an independent regulatory body and forced it to begin reporting to the NBRK. The final disposition of the regulatory bodies for pension funds and asset management companies remained unclear at the moment, however these entities would eventually become a part of the unified regulator. The Decree further stated that the NBRK should draft legislation that would create a unified financial services regulator. Per the Presidential Decree, the draft legislation must be submitted to Parliament by October 1, 2001. Barents RA Stirewalt and TA Gegenheimer collaborated to provide a summary of legal issues surrounding the unified regulator and a draft law that would create the unified regulator. This was submitted to Chairman Marchenko on July 30. Chairman Marchenko used this document as a guide in a discussion with President Nazarbaev on July 31.


## **B. Analyze regulations and supervisory requirements for non-bank financial institutions in Kazakhstan, specifically focusing on micro-credit enterprises**

On May 11 2001, RA Stirewalt took part in a meeting with NBRK representatives, including Chairman Marchenko, representatives of the Kazakhstan Community Loan Fund ("KCLF"), the largest licensed NBF in Kazakhstan, and representatives of ACDI/VOCA and USAID/CAR. The purpose of this meeting was to discuss impediments to growth of NBFs, particularly microfinance institutions. Mr. Marchenko clearly supported the concept of lessening supervision and regulation of microfinance institutions as a trade off for less risk in their activities. RA Stirewalt, with assistance by TA Tina Mendelson, researched of international practices with NBFs including that of the Asian Development Bank, the World Bank, CGAP, and various donor groups providing assistance to the poor around the world.

RA Stirewalt also met individually with representatives from KCLF and the Eurasia Foundation on this topic. In summary, NBFs are treated much the same as commercial banks with regard to supervision, regulation and reporting. RA Stirewalt hopes to limit NBF activity and risk-taking ability through a comprehensive regulation, and thus reduce the need to supervise these institutions closely.

During June 20-23, 2001 RA Stirewalt participated in the "*NIS Policy Forum on Microfinance Law and Regulation*" in Krakow, Poland. RA Stirewalt spoke on the initiatives in Kazakhstan and on various banking supervision topics, as they relate to microfinance initiatives. Material obtained from this Forum was used to deliver a final version of the concept paper on regulation and supervision of non-bank financial institutions in Kazakhstan in July. Deposit taking authority and the amount of prudential supervision to be applied to microfinance entities are, by far, the most contentious issues between regulators and practitioners in this field. RA Stirewalt provided a follow-up article to USAID headquarters office regarding microfinance, the conference and provided certain recommendations for future conferences.

RA Stirewalt delivered the final version of a concept paper on regulation and supervision of non-bank financial institutions, including microfinance institutions, in Kazakhstan. RA Stirewalt met with Chairman Marchenko on July 13 to discuss the document in detail. Chairman Marchenko stated that he agreed with all major issues in the concept paper and discussed these issues with President Nazarbaev. Chairman Marchenko requested that we make reduction of regulatory burden on microfinance institutions a high priority of Barents/ USAID technical assistance through the end 2001.

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**C. Provide at least two training courses for the Banking Supervision Department**

RA Stirewalt delivered a course on “Instructor Training” during the week of April 15-20 with 15 participants. While very few of the NBRK staff teaches classes internally, many do provide outside lectures, including several persons providing seminars at local universities.

On May 18, RA Stirewalt delivered a two-hour lecture on the subject of internal controls and internal audit from an international perspective. The participants included representatives, primarily from internal audit departments, of five banks in Kazakhstan.

In June, RA Stirewalt delivered a one-week course on the topic of asset/liability management, and analysis of liquidity risk and interest rate risk in banking organizations. Fifteen participants attended the course, all from the NBRK.

On July 11, RA Stirewalt delivered a four-hour lecture on international standards relating to internal controls and internal audit of commercial banks. The audience of this lecture was internal and external auditors of commercial banks in Kazakhstan. The participants were attending this lecture as part of their certification process.

**D. Provide assistance to the development of the Kazakhstan Deposit Insurance Fund with regard to key regulations and management oversight**


During meetings with NBRK Deputy Governor Zhangel'din, RA Newton learned the KDIF was considering expanding its coverage to include individual demand deposits and some of the participating banks in the system were complaining that the premium payments were too high. RA Newton responded through meetings with Mr. Akhmetov, Director of the KDIF, that the current insurance coverage for only individual savings deposits might be adequate given the structural changes that remain necessary with the deposit insurance regulations and with liquidation processes. The premium payments by participating banks should remain at a high level annually until the Fund reaches its target balance of 5%.

RA Newton delivered a cash flow model to the Fund for their use in projecting the target balance over a six-year period using different closed bank scenarios. RA Newton also suggested the Fund use an average assets figure to assess the premium over the period rather than a 1<sup>st</sup> day of the month cutoff. Some participating banks receive Government payments on the 1<sup>st</sup> day of the month for immediate payment to recipients. This results in a higher premium than other banks not as heavily involved in this program.

RA Newton provided comments on the draft regulation for amendments to deposit insurance and suggested a more formal governance structure for the Fund. RA Newton proposed an advisory board consisting of participating bankers to replace the current situation of bankers as board members, an obvious conflict of interest precluding any discussion of another bank's operations. Other technical issues were again stressed from previous recommendations.

RA Newton suggested the Fund establish a line of credit with the Minister of Finance to provide emergency funding. The Fund can only invest its assets in Government securities and the Government of Kazakhstan only offers 4-year maturity investment. This may cause a problem if securities need to be sold at a loss to payoff insured depositors.

RA Newton delivered a brief history of the FDIC in the United States and an overview of the FDIC guidelines on the payment of deposit insurance to an individual. The Director of the KDIF, Mr. Akhmetov, remains in the early stages of his career at the KDIF, and these papers are useful to bring him to the level of knowledge in international practice that is needed. Most encouraging in these reports is the similarities

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in the overall development process of the FDIC and the KDIF. This helped the KDIF to form meaningful near-term and long-term strategies.


RA Newton and TAs Cooke and Gegenheimer met with Mr. Akhmetov to discuss the entry and exit procedures to the KDIF as drafted by Mr. Akhmetov. Advisors made several suggestions on the procedures. Additionally, RA Newton and TA Gegenheimer provided several detailed comments on the overall deposit insurance regulation.

On May 14 and 15, RA Newton and TA Cooke delivered seminars on international deposit insurance and banking crisis issues. The seminars, prepared by TA Cooke and TA Mendelson, provided a broad overview of these international issues for approximately 30 attendees and expanded the local knowledge base in the area of banking crisis management. Topics covered included the role of deposit insurance and the timing of liquidation activities. TA Cooke also discussed the role of asset management companies in different countries around the globe.

RA Newton accompanied two representatives from the National Bank (Mr. Akhmetov, Director of KDIF; and Mrs. Badyrlenova, Head of Bank Liquidation Department) to the United States for a study trip to the FDIC. RA Newton acted as a bridge by outlining certain differences between Kazakhstan and the United States in the areas of deposit insurance and bank liquidations. This session was one of the most interesting sessions of the study trip as neither Mr. Akhmetov nor Mrs. Badyrlenova has received a large overview of banking supervision activities previously. As the Kazakhstan delegation was the first foreign delegation to visit the Operations Center, the FDIC provided a truly outstanding program. The participants were very pleased with the study trip and are scheduled to make a presentation to senior management of the NBRK. After returning from the training mission at FDIC in Washington DC and Dallas, advisors reviewed all the extensive materials FDIC furnished on CD format.

RA Newton and TA Ashear, who was deployed to strengthen the deposit insurance assistance, delivered comprehensive procedures for paying off depositors through a paying agent bank. TA Ashear met with representatives of commercial banks and with the banking supervision department to assess the types of technology in use at banks and the types of accounts that banks maintain with a view toward potential liquidation. The findings of these interviews were incorporated into the procedures manual. Advisors continued to propose alternatives to a straight pay-off of depositors, such as a purchase and assumption transaction, but at present, the law does not allow for anything but a pay-off. Additionally, advisors have proposed that the KDIF develop the capability in house to pay depositors as a back up plan. The process to calculate an insured deposit is cumbersome due to the current regulation requiring insurance coverage exclusion for accounts with higher interest rates. We have continually proposed taking these qualifiers out of the regulation to simplify the system. The result is that the present deposit insurance regulation is overly complex and banks and depositors are confused about coverage. Advisors firmly believe that an insured bank failure today would result in many depositors, who thought they were insured, not being covered.

At the request of Mr. Akhmetov, TA Gegenheimer delivered a document titled "Suggested Points for a Deposit Insurance Law." This would move the legal provisions concerning deposit insurance from the NBRK Regulation on Mandatory Collective Insurance to legislation enacted by the Parliament. It is preferable for the legal authorities of a public body to be clearly set forth in legislation rather than regulation. While the NBRK has done a commendable job in starting the KDIF, advisors suggested they consider transitioning it into an independent agency in the future. Advisors further suggested the NBRK Liquidation Department be combined with the KDIF in this process although this may be problematic since they presently liquidate insurance companies in addition to banks.

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**E. Provide assistance to the development of the Bank Liquidation Department with regard to key regulations and management oversight**

Through several meetings with the Head of Liquidation Division, we have been asked to provide input on their “draft” Regulation defining the “forcible liquidation” process. The Liquidation Division is charged with responsibility for overseeing Liquidation Commissions per the March 2, 2001 Banking Law. This is a change from past authority. As a result of this new authority, comments were also requested on standard reporting formats from the Liquidation Commissions.


RA Newton made recommendation on the bank resolution/ liquidation process in Kazakhstan. Over-involvement of the Courts, the Creditor Committees and the outside Liquidation Commission appointed/removed by the Courts all combine to produce an inadequate environment in which to liquidate banks. Indeed the collection experience for the banks closing from 1994 to 1998 revealed very poor results with many liquidations unable to even pay the second priority payment for former bank employees accrued salaries much less any return for depositors. Typically, when funds are collected the Liquidation Commission used the funds to pay current employees salaries and the salaries of the Liquidation Commission.

Given such liquidation environment, advisors proposed special emphasis on Provisional Administration and Purchase and Assumption transactions to initiate bank resolution process as early as possible before a bank is formally placed in liquidation by the courts. In this effort, advisors met with team leader for the BISD’s Problem Banks Unit to discuss the role of NBRK in provisional administration. Advisors again stressed the importance of using a purchase and assumption transaction to keep good assets in the banking system and pointed out sections of the law and bank deposit agreements that may be problematic in executing this transaction. Both the KDIF and Liquidation Division were interested in purchase and assumption transactions and this issue is ongoing pending a legal review of the system for liquidating banks.

RA Newton and TA Gegenheimer met with Ms. Sizova, Deputy Director of the NBRK Legal Department to discuss the current legal process in Kazakhstan for liquidating banks as compared with the legal systems in other countries. TA Gegenheimer advised that countries with the most efficient legal process were those that did not have the continuing involvement of the Courts and Creditors Committees after the initial decision to liquidate the bank. Deposit insurance funds have a strong financial interest in liquidating banks to recover their funds quickly to pay-off depositors. In Kazakhstan, the Courts make the decision to place the bank in forcible liquidation. They also appoint the Liquidation Commission including the Chairman who in turn appoints the Creditors Committee. The Creditors Committees have approval authority for certain actions of the Liquidation Committee.

The NBRK Liquidation Department also oversees the operations of the Liquidation Commission using reports and on-site visitations. The key documents covering the liquidation process are the Banking Law of March 2001, the NBRK Regulation for Forcible Liquidation, the Bankruptcy Code and the Civil Code. All of these documents are conflicting. The liquidation process in Kazakhstan more closely resembles a bankruptcy proceeding than bank liquidation in more developed economies.

Ms. Sizova stated that Parliament discouraged NBRK from primary responsibility for bank liquidations. In the mid-90s NBRK placed many banks in liquidation using a non-judicial process and appointing their own Liquidation Commissions to do the liquidation work. The outcome of these liquidations was very unfavorable to creditors, probably due to the very poor financial condition of the banks and asset stripping that occurred before being placed in liquidation. Nevertheless, in the recent Banking Law, the non-judicial process was dropped along with direct involvement of NBRK.

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TA Gegenheimer recommended a more streamlined version of the Banking Law to correct the many flaws in the current system. He provided an extensive summary and overview of the Kazakhstan liquidation process with several recommendations for change in order to gain the legal authority to complete a purchase and assumption transaction. The ability to complete a purchase and assumption transaction would greatly enhance the liquidation process and improve recoveries immensely.

RA Newton developed procedures for NBRK Liquidation Division and KDIF to use for processing claims at a forcibly liquidated bank. The procedures are based on Kazakhstan Banking Law and regulations of both Liquidation Division and KDIF. Claim processing is a major part of the Liquidation Commissions responsibilities after a bank is placed in liquidation. The Commission's work is subject to the oversight of the Liquidation Division and for deposit insurance, the KDIF. These procedures are intended to standardize the work of the Liquidation Commissions and simplify the claims process.

RA Newton met with the NBRK Liquidations Department to discuss proposed offset procedures and a liquidation balance sheet. Currently the Liquidation Department has the Liquidation Commissions offset everything that can be offset. Since this is exactly what our procedure called for, we wanted this left in place and to work on how the offsets would work with the deposit insurance fund paying off depositors in an insured bank. The primary concern is with timing. The KDIF is required to pay-off depositors within 60 days, while the claims process including offsets can run for 6 months to three years.

The standard liquidation balance sheet is very misleading and continues to show the bank with positive capital even though it was hopefully insolvent. We advised that per international accounting standards, liquidations are based on a "cash accounting basis" not an accrual basis. Oddly, the NBRK's Accounting Department has urged the Liquidation Department to account for liquidating banks on an accrual basis. This recommendation violates one of the most basic principles of accounting standards, that accrual accounting assumes companies are a "going concern."


#### **F. Assist the NBRK with general bank supervision advice**

Merger activity. RA Stirewalt met with staff members of the BSD to discuss potential enforcement actions or prudential methods of handling a highly sensitive matter regarding a bank's acquisition of shares to affect a merger transaction. The bank in question loaned money to several companies without presentation of financial information secured by shares of the bank's acquisition target. The companies are expected to default on the loans given, thereby giving a 32% stake in the acquisition target to the acquiring bank, without the necessary disclosures that would be required if the bank acquired the shares outright. In essence, the acquiring bank took advantage of legal loopholes in current legislation to accomplish this transaction.

Asset Management. RA Stirewalt met with persons from the off-site analysis area of the BSD to discuss trust operations and trust accounting for banks. The area of asset management is not well understood by persons from the BSD or the NBRK accounting department. RA Stirewalt elaborated on the difference between "assets under management" and "owned assets" with respect to trust department accounting.

Electronic/ Internet banking. RA Stirewalt reviewed a revised draft of a regulation on electronic banking. The responsibility for regulation of electronic banking activities has been removed from banking supervision to the Payment Systems Division. This greatly enhances the ability to make sense of technology. RA Stirewalt discussed the regulation and suggested amendments to the Payments Systems Division, based on documents from the Basle Committee for Banking Supervision on risk management principles for electronic banking activity.



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Capital amnesty program. On July 13, 2001 a 45-day capital amnesty program ended. During this program, persons who had opened foreign bank accounts illegally in the past were allowed to repatriate their funds with no penalty and no additional tax liability. The program was originally designed to be 30 days in duration; however, the program was extended to 45 days due to actual repatriation being less than expected. Many groups lobbied against this program as a way only to enhance the wealth of the already rich. In the end, it appears the program was successful in its objective of bringing new funds to Kazakhstan. Slightly over \$US480 million dollars were repatriated to Kazakhstan from foreign accounts during this capital amnesty period, nearly 50% of which came in the final two days of the program. This is equivalent to 24% of the existing deposit base in the entire commercial banking system in Kazakhstan. This cash infusion has had a positive effect on the economy in Kazakhstan.

### **PHASE III – AUGUST 2001 THROUGH DECEMBER 31, 2001**


#### **A. Assist the NBRK with further development of the microfinance sector, including working closely with the European Union on developing a law on credit unions**

##### **Law on Microlending Organizations**

RA Stirewalt met on several occasions with the NBRK's senior management team and with members of the BISD Methodology Unit to discuss the concept paper for microlending organizations in Kazakhstan that was developed in Phase II of our assistance. Following discussions with the NBRK representatives, RA Stirewalt also met with representatives of the Kazakhstan Community Loan Fund, a USAID-sponsored micro-lender. Feedback from practitioners has been extremely helpful in developing documents for the NBRK relative to microfinance. RA Stirewalt met with Deputy Governor Kolpakov, members of the BISD and representatives of the European Union to discuss an overall strategy for development of a law on microlending institutions and a law on credit unions. Chairman Marchenko sent a letter, dated July 17, 2001 to the President of Kazakhstan regarding his view of microfinance and has applied a large degree of pressure on these departments to finalize these laws in the near term.

RA Stirewalt delivered a draft law on microlending organizations to the NBRK to be used as a discussion document. The BISD also drafted a version of this law to be used a discussion document. Two major differences exist in the versions developed by the BISD and the version developed by RA Stirewalt. The BISD does not wish to license, regulate or supervise microlending institutions in Kazakhstan. RA Stirewalt initially felt the BISD should apply streamlined licensing processes, limited regulation and retain the right to supervise these institutions. The BISD felt licensing would place the burden of safety and soundness on their shoulders, and thus preferred a hands-off approach, allowing the Ministry of Justice to be the licensing authority and the Ministry of State Revenue to be the primary regulator of these institutions.

During October, RA Stirewalt met with representatives of the BISD on several occasions concerning developments in the Law on Microlending Organizations and the Law on Credit Unions. Following this series of meetings, RA Stirewalt provided written commentary regarding necessary changes to the Law on Microlending Organization to make this more effective legislation. These recommendations culminated in a meeting with Deputy Governor Kolpakov, members of the BISD, and members of the NBRK's Legal Department on October 18. During this meeting, it became more obvious that the NBRK staff continued to treat microfinance institutions like commercial banks in certain respects, and potentially hindering their future growth. RA Stirewalt organized a tour of a micro-lender (USAID-sponsored KCLF) on October 19. This tour proved to be beneficial as a member of the NBRK, partially responsible for drafting this law, was able to witness the actual operations of a group lender microlending organization. Several changes were made to the draft law following the general meeting and visitation to KCLF.

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While the draft law is much improved since the first version was discussed, certain areas continue to be of concern. The following are the primary areas of concern at this point:

- 1) the draft law requires microlending organization to legally form as partnerships only, not allowing legal formation as a joint stock company;
- 2) the draft law prohibits the microlending organizations from issuing securities (must be a joint stock company to issue securities); and
- 3) the draft law has too many intrusive requirements regarding the daily operations of a microlending organization. RA Stirewalt believes each of these items should be left to the management of a microlending organization to decide, rather than be in the form of a law.

During November, RA Stirewalt continued discussion of the draft Law on Microlending Organizations. The NBRK has delivered final versions of each of the laws to various Ministries in Kazakhstan for their respective commentary. RA Stirewalt assisted the NBRK with further refinements to the laws before their delivery to Parliament. Following commentary from Ministries, the Law on Microlending Organizations appears to be complete and reasonable. While still somewhat intrusive to microlending operations, the law seems to address the basic aspects of microlending in a reasonable manner. As noted earlier, the NBRK is the author of this law, yet will not license, regulate or supervise microlending operations from the passage of this law forward.


### **Law on Credit Partnerships**

RA Stirewalt worked closely with a team from a European Union / Tacis project regarding drafting a law on credit unions in Kazakhstan. RA Stirewalt provided the BISD with research from the World Council on Credit Unions, Inc. and the EU / Tacis team provided advisory assistance on the development and purpose of credit unions. RA Stirewalt provided commentary to the BISD and Deputy Director Kolpakov, similar to that for microlending organizations, regarding credit unions. The BISD acknowledged more responsibility for licensing, regulation and supervision of these entities although significant areas of non-clarity still existed, including the definition of “members” of a credit union, “member shares” and “member deposits.”

This law drafting process took a turn on the wrong direction in late 2001. Without notice, the BISD changed the name of the Law on Credit Unions to the Law on Credit Partnerships. Apparently, the Chairman of the NBRK said he did not want a new type of financial institution in Kazakhstan (credit unions), but wanted to improve an existing institution, credit partnerships. The BISD did not have the expertise or experience to draft this legislation and this fact was obvious in its final form. In essence, the BISD has attempted to draft a hybrid law that would encompass credit partnerships and credit unions. However, as a result of this hybrid attempt, the current version significantly complicates the existing credit partnerships and makes formation of credit unions nearly impossible. RA Stirewalt worked closely with a team from the European Union on this issue. However, the EU’s budget for this assistance is small so their advisors were only present in Kazakhstan for approximately two weeks.

### **B. Assist the NBRK in their efforts to create a unified financial regulator in Kazakhstan**

RA Stirewalt provided considerable research for the NBRK in their efforts to create a unified regulatory body, encompassing banking supervision, insurance supervision, pension supervision and securities regulation. The focus of research was on various forms of unified regulators around the globe, primarily the United Kingdom and Hungary. The United Kingdom has arguably the most advanced model for a unified regulator, while Hungary is a more reasonable peer to Kazakhstan in terms of development. RA Stirewalt also discussed proposed organizational structures with the BISD, within the unified regulator.

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RA Stirewalt discussed the possibility of a USAID-funded trip to the United Kingdom to hold talks and discussions with the UK's Financial Services Authority. The NBRK counter-offered that Chairman Marchenko would visit the Financial Services Authority himself, yet the NBRK would like financial assistance in visiting the unified regulatory bodies in Finland and Ireland. RA Stirewalt met with Deputy Governor Kolpakov to discuss this trip and to outline the possible methods of USAID assistance.

The NBRK Legal Department provided a draft law creating the unified regulator and showing various changes in relevant legislation. RA Stirewalt and TA Gegenheimer discussed this briefly with NBRK attorney Mr. Murat Baisinov.

### **C. Provide at least two training courses for the Banking Supervision Department**

RA Stirewalt delivered a one-week course covering an introduction to asset and liability management techniques during the week of September 3-7, 2001. This course addressed evaluation and management of liquidity risk and interest rate risk for commercial banks. A total of 16 students attended this course, including 6 from the NBRK. The remaining participants were from commercial banks operating in Kazakhstan.


TA Vance delivered a two-week course covering more advanced asset and liability management techniques in a case study format during the weeks of September 10-21. A total of 24 students attended this course, including 10 from the NBRK. The remaining participants were from commercial banks operating in Kazakhstan.

### **D. Provide assistance to the development of the Kazakhstan Deposit Insurance Fund with regard to key regulations and management oversight**

The Chairman of the KDIF and NBRK Deputy Governor Zhangel'din requested assistance in drafting a revised regulation for the KDIF, in response to the final version of the Financial Stability Forum's best practices guidelines for deposit insurance, dated September 7, 2001. RA Stirewalt read the Financial Stability Forum document and offered several items of assistance to the KDIF in connection with the document's findings and recommendations.

Since the KDIF was created in November, 1999, its governing regulation were revised four times. The NBRK requested to comprehensively revise the regulation in November 2001, with a goal of not amending the regulation again at least for another 2-3 years. RA Stirewalt provided a summary document addressing many of the most difficult and controversial issues with deposit insurance, such as the size of premiums, the target balance of the deposit insurance fund, the amount of coverage to be provided to insured persons, and various methods for determining insurance coverage. The BISD has, to date, been the responsible party for drafting the deposit insurance regulations. RA Stirewalt has recommended removing this responsibility for the BISD to reduce the temptation to confuse the goals and purposes of deposit insurance regulation (simplicity for depositors and efficiency for bank liquidations) with goals and purposes of banking supervision (safe and sound operations, risk management, safe payment system, functioning financial intermediation, and compliance with law). The Chairman of the KDIF has the capability to assume this role.

All Barents advisors (Stirewalt, Newton, Ashear and Gegenheimer) have been assisting with recommendations for amendments to the deposit insurance regulation. Advisors have met with management of the KDIF, with commercial bankers, and with BISD personnel, each on several occasions to discuss various recommendations designed to simplify deposit insurance for bank depositors. The current regulation seems to mix the goals of deposit insurance with bank supervision, and results in a document that is confusing for banks and their customers. The two most significant areas of concern are:

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interest rate limits for insurance coverage and co-insurance. The current regulation states that deposits with an annual interest rate greater than 14% for Tenge accounts and greater than 8% for Dollar accounts are uninsured. Co-insurance relates to the system of deposit insurance coverage, whereby 200,000 Tenge is covered at 100%, then stepping through a six-layer sliding schedule resulting in a 5,000,000 Tenge account receiving 1,000,000 in insurance coverage. Both of these issues violate the basic principles of simplicity for depositors and unnecessarily complicate the deposit insurance payoff and bank resolution process. However, these items appear to have the support of the Chairman of the NBRK, thus correcting these issues would be highly difficult.

Barents advisors delivered a lengthy analysis of weaknesses and potential pitfalls with the existing wording of the deposit insurance regulation. The Director of the BSD is the strongest opponent of simplifying the deposit insurance regulation. The advisors' letter, addressed to Chairman Marchenko, highlighted the potential damage to the deposit insurance system if the regulation remains in its existing form. Despite achieving agreement with the Director of the KDIF, the Association of Financiers, and the commercial banks advisory board to the KDIF, and addressing the concerns of depositors in the public media, Chairman Marchenko remained in general agreement with the Director of the BSD on the wording of the deposit insurance regulation.

Earlier in 2001, Barents advisors recommended removing commercial bankers from the supervisory board of the KDIF. The NBRK and KDIF agreed with this recommendation and moved to create an advisory board of commercial bankers for the purpose of providing industry input to the KDIF. The new advisory board was selected in September, consisting of representatives from seven banks.

In late 2001, it became clear that a commercial bank with deposit insurance ("Komirbank") was near failure. Mr. Akhmetov discussed Komirbank and the problems associated with the institution with Barents advisors. Barents advisors assisted Mr. Akhmetov with his preparation and his pre-liquidation course of action, focusing on worst-case scenarios for planning. The primary short-term objective was to determine the number of insured accounts, the total exposure to the KDIF, and the market (adjusted) value of the problem bank's assets. An area of concern was the conservator's ability to determine the adjusted value of the assets. In November 2001, Komirbank's license was removed and a petition for liquidation was entered into the courts. In response to this failure, the NBRK advanced (transferred) money to Halyk Savings Bank and then transferred all individual (natural person) deposit accounts and all pension fund investments to Halyk. The terms of the advance (transfer) were not finalized at year-end. By guaranteeing all individual deposit accounts (not just the insured portion) and all pension fund accounts (not covered by deposit insurance), the NBRK has significantly increased moral hazard and minimized the value of deposit insurance.

#### **E. Assist the NBRK with general bank supervision advice**

Asset quality and provisioning requirements. RA Stirewalt drafted and delivered a normative (regulation) on asset quality and provisioning requirements for commercial banks. The current normative is much more conservative than international banking supervision standards, and deviates significantly from International Accounting Standards.

Bank accounting. The NBRK's Accounting Department requested the assistance of RA Stirewalt with several accounting issues related to insurance companies. The Accounting Department delivered a list of 13 questions, and RA Stirewalt provided brief answers to each of these questions. This process was coordinated with Mr. Richard Webb who is working with the Financial Protection Initiative in the area of insurance industry development.

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Off-site advice. TA David Hawkins provided expert assistance in the area of off-site supervision, reporting and management information during November and December. TA Hawkins investigated the current information flow and reporting forms for the off-site analysis division in the BISD. A written summary of this review was provided to the BISD in December, with several recommendations for eliminating or changing many of the banking supervision financial reports and enhancing the overall off-site analysis process. Through previous recommendations from TA Hefty and these recommendations from TA Hawkins, the regulatory burden of reporting from commercial banks has been significantly reduced.

Money laundering. RA Stirewalt provided assistance to the US Embassy and to USAID in the area of money laundering. This is an increasingly high profile issue following the events of September 11<sup>th</sup>. The NBRK had not previously focused on money laundering as a critical issue in the past, yet appears committed to improving their systems in the near future. RA Stirewalt and TA Gegenheimer have had several discussions with the BSID and the NBRK Legal Department regarding this issue.

Risk management policy. RA Stirewalt met with several lending and lending support officials from Bank Turan-Alem on December 12 to discuss internal controls and risk management tools for lending. This is the first round-table discussion in a series of round-table discussions with Bank Turan-Alem on lending practices. Through making lending processes more efficient, Bank Turan-Alem hopes to be able to penetrate the small- and medium-sized loan market more effectively. The bank also has a keen interest in agricultural lending.

SME Lending. RA Stirewalt met with the public fund "Intellectual Property Laboratory" on December 20 following a recommendation from Chairman Marchenko. The Intellectual Property Laboratory is attempting to help small businesses with innovative ideas, to introduce these small businesses to banks in order to receive start-up funds or loans and to focus on ideas such as franchising, licensing, and leasing. RA discussed strategies for approaching commercial banks and how to market the funds training services in Kazakhstan. RA Stirewalt promised continued cooperation with this public fund and also provided names and contact information of the USAID Trade and Investment Project and the USAID Small Business Advisory Projects to further assist in these areas.


#### **PHASE IV – JANUARY 2002 THROUGH MARCH 31, 2002**

##### **A. Continue assistance toward development of the microfinance sector, including working closely with the European Union on developing a law on credit unions**

RA Stirewalt, in coordination with the EU advisor on credit unions, provided a letter discussing of the problematic issues regarding the Law on Credit Partnerships (Unions) to Chairman Marchenko. In this letter, RA Stirewalt explained the difficulties of combining regulation of credit partnerships and credit unions, as the purposes, operations and inherent risks with these entities are considerably different.

RA Stirewalt also met with BISD personnel in January to discuss applicable regulations and financial analysis techniques for credit partnerships and credit unions. RA Stirewalt explained the different regulatory and supervisory needs of entities that do not take deposits and do not lend outside their membership (credit partnerships) and entities that may take deposits and lend only to their members (credit unions). RA Stirewalt also arranged for a group of persons from the BISD to visit credit union regulators during a tour of US regulatory agencies in February. One of the persons participating in this training tour has a key role in drafting law and regulation regarding credit unions and credit partnerships.

RA Stirewalt assisted the BISD with advice regarding supervision and regulation of existing rural credit partnerships. Rural credit partnerships are mainly serving the agriculture community in Kazakhstan, do

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not take deposits, and receive significant funding by the Ministry of Agriculture. RA Stirewalt assisted the BISD with a strategy of placing more burden of regulation and supervision of these rural credit partnerships to the Ministry of Agriculture, whose money is at stake. This is a form of market-oriented supervision that makes the BISD much more efficient. The BISD should be focusing most of its attention on deposit-taking institutions; particularly those that have systemic risk implications. Rural credit partnerships do not fit either of these criteria.

**B. Continue to assist the NBRK in their efforts to create a unified financial regulator in Kazakhstan and coordinate efforts with the IMF**

RA Stirewalt met with the IMF Resident Representative to discuss progress in this area. The IMF provided a set of recommendations regarding creation of a unified regulator to the NBRK. These recommendations were consistent with the suggestions made by USAID advisors, keeping the unified regulator under the structure of the NBRK as a department or as a subsidiary.

RA Stirewalt met with the Association of Financiers in March to discuss, among other things, the unified financial regulator in Kazakhstan. The Association of Financiers believes the unified regulator should be an independent agency within the Government of Kazakhstan. We do not disagree with this thought as a long-term goal. However, we have advised that it should remain a subsidiary of the NBRK for an interim period before eventually becoming independent. By remaining a subsidiary, the unified regulator would retain the political weight of the NBRK, and would be allowed to focus on critical issues of supervision without getting distracted by administrative hurdles that are associated with forming a new agency. Once the subsidiary is effectively functioning as a subsidiary of the NBRK, it can turn its attention to becoming independent and addressing issues such as forming an internal legal counsel, accounting unit, and its own personnel policies. We estimate this process to be complete within 1-2 years. The Association of Financiers believes the political power can be achieved with proper membership on the unified regulator's supervisory board and other administrative issues would not be difficult to overcome.


**C. Continue to provide training courses for the Banking Supervision Department. A course will be delivered in February covering the theory of asset and liability management, with a follow-up advanced course (BankExec) to be delivered in March. In addition, the NBRK is looking closely at the failure of the BISD to recognize critical problems that caused of a recent bank failure and how to prevent this from re-occurrence. This will necessitate a review of this bank failure, and significant enhancements to the existing credit risk analysis and credit risk management course**

The "post-mortem" analysis of the failed bank ("Komirbank") has highlighted the issue of credit analysis and valuation of bills of exchange ("veksels"). RA Stirewalt assisted the BISD with a regulation on bills of exchange and with better valuation techniques.

RA Stirewalt delivered a lecture on the New Basle Capital Accord to a banking conference sponsored by the Almaty Bank Training Center on January 18-20. During this conference, RA Stirewalt also participated in several round table discussions regarding the potential risks and trends in the Kazakhstan banking sector in 2002. This presentation was also provided to the BISD Methodology Unit.

During the week of February 18-22, RA Stirewalt delivered the theory-based course on Asset / Liability Management, including segments on evaluation of liquidity risk and interest rate risk. Fourteen participants attended the course held at the NBRK's training facility.

During the weeks of March 11-25, TA Vance delivered the Advanced Asset / Liability Management course, titled "BankExec", to 25 students.

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**D. Continue to provide assistance to the development of the NBRK's Liquidation Department and the KDIF with regard to key regulations and management oversight. Particular assistance will be delivered discussing the feasibility of implementing concepts from the USAID-sponsored Distressed Debt Resolution Workshop in March**

RA Stirewalt has worked closely with USAID headquarters personnel (Lawrence Camp and Rebecca Richards) in organization of participants for a "Distressed Debt Resolution Workshop" which was held in Budapest, Hungary, during March 13-15. RA Stirewalt has acted as a coordination of information between the NBRK, USAID, and the Academy for Education and Development (AED).


RA Stirewalt, in coordination with TAs Newton and Gegenheimer, researched common practices for liquidation of collateralized obligations in a failed bank. Currently, the bank liquidation priority places secured creditors in sixth position when liquidating a bank. International practice places collateralized obligations as the first priority, all of which must be settled before settlement of depositors, unsecured creditors and shareholders. This is consistent with the advice given by advisors of the Financial Protection Initiative in their efforts to create a secondary market for mortgage obligations in Kazakhstan.

TA Newton arrived on March 15 to provide assistance to the KDIF and the NBRK's Liquidation Department. The first matter to be reviewed were recommendations made by the Association of Financiers on ways to improve the KDIF. TA Newton assisted the Director of the KDIF with this review. TA Newton also provided assistance to the NBRK Liquidation Department in their digestion of materials obtained at the "Distressed Debt Resolution Workshop" held in Budapest. The participants enjoyed this workshop and believe they may have practical applications for the materials they gained. The participants also benefited from meeting several of their counterparts in this region and learning of common problems.

**E. Assist the NBRK with general bank supervision advice. The NBRK has requested assistance with developing a better risk management regulation for commercial banks and a new and improved capital adequacy regulation. Each of these regulations is in response to a recent bank failure. The NBRK is also interested in a usury law that would place a legal cap on interest rates for consumer and small business loans**

RA Stirewalt delivered comments on a draft regulation for bank risk management, basic risk modeling, and internal controls. This was provided to banks as a "recommendation" or "guidelines" during 2001. Chairman Marchenko wanted to change these recommendations to "requirements" in the form of a regulation, following the failure of Komirbank. In his commentary, RA Stirewalt highlighted the fact that additional regulations and requirements are not necessarily consistent with prudential supervision, cannot prevent banks from failing and only serve to burden the good banks unnecessarily. Only prudential supervision and better risk identification abilities can serve to mitigate the risk of failures, although even the best of prudential systems cannot prevent failures. RA Stirewalt did discuss the possibility of using the bank's external auditors as an effective method of augmenting bank supervision (not replacing it) through an annual risk management review process, separate from the financial audit process.

RA Stirewalt delivered comprehensive research and a draft regulation on the topic of country risk for the BISD. Country risk is the risk to earnings or capital arising from the possibility that a sovereign state or borrowers of a particular country may be unable or unwilling to fulfill their obligations towards a foreign lender and/or investor for reasons beyond the usual risks which arise in relation to all lending and investments. This risk is required to be addressed by Basle Core Principle #11. RA Stirewalt provided a draft regulation on country risk, a research paper on management of international lending exposures, a sample country risk regulation from the Central Bank of Holland to the BISD and brief on-site inspection procedures on this topic. In addition, RA Stirewalt held several discussions with the BISD Methodology

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Unit to discuss the purpose of monitoring this risk and the potential damage to a bank's earnings performance and capital adequacy if this risk may cause.

RA Stirewalt was asked to prepare a document addressing the importance of banking supervision in the financial sector. The NBRK has come under several direct attacks from Parliament for the failure of KomirBank at the end to 2001. Chairman Marchenko wanted an overall summary of the purpose and importance of banking supervision for the benefit of the new members to the supervisory board. RA Stirewalt took this opportunity to draft a cover letter to this paper with several recommendations for improvement in banking supervision practices and to provide a review of some of the department's weaknesses. Chairman Marchenko reacted positively to many of the recommendations made.

RA Stirewalt drafted feedback on the second version of the BISD's proposed "Regulation on Bank's Asset and Contingent Liabilities Classification, Establishment of Provisions (reserves) and Asset Write-Offs" for commercial banks in Kazakhstan. The BISD made certain improvements to this regulation since the initial version was developed in the autumn of last year; however, additional improvements were necessary. The regulation is not consistent with modern banking supervision practices and does not adhere to international accounting standards. Further, this regulation may damage the ability of small- and medium-sized businesses to obtain bank credit at a reasonable cost, and may also negatively impact the residential mortgage loan market. RA Stirewalt coordinated this review with representatives of the EBRD Small Business Development Fund. RA Stirewalt also encouraged the EBRD to draft a response independently, to validate these findings.

RA Stirewalt and TA Gegenheimer delivered a draft version of a usury law for lending Kazakhstan. A usury law is an attempt by the NBRK to bring down the lending rates in Kazakhstan to a pre-set maximum rate of interest. While advisors provided a draft version of this law as requested, our advisors also provided strong evidence and commentary why better disclosures are a more effective manner of dealing with this issue than a usury limit. Advisors specifically highlighted the potential damage to microfinance lending if a usury is implemented without due caution.

#### **F. Assist the NBRK with general bank supervision advice**

Mortgage banking. RA Stirewalt met with the Chairman of the Kazakhstan Mortgage Company, Ms. Maiko Sagindykova, on January 3. Ms. Sagindykova requested a meeting to discuss mortgage loan pricing issues, particularly the topic of proper base indexes for mortgage loan interest rates for adjustable rate loans. RA Stirewalt followed the discussion with a written narrative on this topic, and provided this written narrative to advisors on the Financial Sector Initiative.

RA Stirewalt met with representatives from the Karachaganak Petroleum Operating Company ("KPO") from Aksai, Kazakhstan. KPO is interested in attracting new employees to a community (Aksai) that is not generally attractive. KPO management was interested in evaluating alternatives such as establishing a credit union, initiating an on-lending program through a commercial bank, or developing a direct lending / leasing program themselves. All of these alternatives are targeted at mortgage lending. RA Stirewalt drafted a paper explaining the basics of these alternatives in Kazakhstan and discussed this paper with KPO management.


Risk management. RA Stirewalt continued to meet with lending officers and lending support staff from Bank Turan-Alem to discuss internal controls and risk management tools for lending.

Bank accounting. RA Stirewalt was asked to attend a meeting at the offices of NBRK Deputy Governor Abdullina on March 11. Other attendees at this meeting included the Almaty Bank Training Center and



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several prominent commercial banks. The NBRK is attempting to develop detailed training courses for International Accounting Standards, including several case studies. Mrs. Abdullina wanted to enlist the assistance of the bankers and donors to this process. This type of open cooperation between the NBRK and commercial banks is highly positive, given that the NBRK cannot keep pace with developing accounting standards for a multitude of new banking products and services.

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## PHASE V – APRIL 2002 THROUGH SEPTEMBER 30, 2002

### **A. Assist the NBRK with developing and delivering formal training courses on communications techniques, capital adequacy normatives and credit risk management**

RA Stirewalt has begun preparation of a course on the New Basle Capital Accord and the National Bank's capital adequacy prudential normatives in light of the changes in capital regulations currently under negotiation. The NBRK decided to delay delivery of a course on communication techniques to the fall of 2002. This decision was motivated by additional time necessary to devote to amendments to prudential normatives.


RA Stirewalt prepared and delivered a comprehensive document providing a methodology for calculating how much capital banks should maintain based on various facts and the bank's risk profile. The methodology document includes capital allocations for credit risk, liquidity risk, interest rate risk, foreign exchange risk, price risk, operational risk and risk factors for the structure of the bank and its affiliates. RA Stirewalt discussed the usage of this document with the BISD Methodology Unit, and we will include this document in future training sessions on capital adequacy.

TA Daniel Callis and TA Mendelson finalized three case studies, including instructor notes, for a credit risk management course to be delivered in the fall of 2002 or early 2003. The case studies focus on three industries that are prevalent in Kazakhstan; an oil service provider, an agriculture business, and a commercial real estate development. Case studies have proven to be the most effective method of learning, and a focus on Kazakhstan-specific industries should enhance the learning process further.

### **B. Provide technical assistance on consistency of National Bank capital adequacy regulations with the original Basle Capital Accord and the New Basle Capital Accord that remains in draft form**

Late in 2001, Mr. Oraz Jandosov was appointed Chairman of the Kazakhstan Association of Financiers. Mr. Jandosov is a former Governor of the NBRK, former Minister of Finance, and former First Deputy Prime Minister of Kazakhstan. More importantly, Governor Marchenko has strong respect for Mr. Jandosov's capabilities and reputation. As such, Governor Marchenko requested comprehensive feedback on NBRK banking regulations, including capital adequacy, to be delivered by the end of March. Governor Marchenko stated that the NBRK would consider any changes the Association of Financiers recommended. This is a highly positive step toward more open communication and more responsiveness to regulatory burden in the banking industry. Less regulatory burden means more efficient banking operations and more funding that is available for lending.

The Association of Financiers developed a 40+-page table of recommendations for the NBRK's consideration. Governor Marchenko forwarded this table to RA Stirewalt for his review and recommendations relative to consistency with the Basle Committee and common international standards for banking supervisors. RA Stirewalt developed a lengthy response wherein he agreed with approximately 60-70% of the Association's recommendations. The NBRK's BISD agreed with approximately 10%-20% of the recommendations. Considerable time has been devoted in April to negotiations with the differences between the Association, RA Stirewalt and the BISD. The majority of time has been devoted to capital adequacy regulations for banks and for banking groups. These negotiations culminated in a May 30<sup>th</sup> meeting between Chairman Marchenko and the BISD, and Mr. Jandosov, the Association of Financiers and the commercial banks. RA Stirewalt participated in this meeting. Final agreements between Chairman Marchenko and Mr. Jandosov were agreed in principal, and left to finalize by the BISD, with RA Stirewalt's assistance.

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**C. Continue to provide assistance to the development of the NBRK's Liquidation Department and the KDIF with regard to key regulations and management oversight**

Advisors continued to stress the transparency of "front office" operations of deposit insurance, while "back office" operations are subject to negotiations. It seems that the NBRK continues to use deposit insurance as an enforcement tool for bank supervision. The banks and the depositors are also confused about deposit insurance coverage amounts, which could lead to reprisal against the deposit insurance system when a bank is declared insolvent. TA Newton and RA Stirewalt have generally agreed with the Association of Financiers on their recommendations; however, Governor Marchenko and particularly the BSD Director are resistant to change on many of these issues. The NBRK Chairman wants to use the deposit insurance fund scheme as a way to reduce interest rates in Kazakhstan. Reduction of interest rates is a laudable goal, yet we do not believe usage of the deposit insurance scheme is the proper method of achieving this goal.

The Director General of the KDIF has been asked to resign by Chairman Marchenko due to personal conflicts. Mr. Akhmetov constantly wanted to focus the KDIF on transparency to the depositor, while the NBRK wanted to make the KDIF more of a banking supervision tool and a method of controlling interest rates. In the end, the KDIF did not need a strong leader because the NBRK Chairman and the BSD determined all critical decisions regarding the fund's operations independently from the insured banks.


**D. Assist the NBRK with general bank supervision advice**

Money laundering and anti-terrorist activity. RA Stirewalt assisted two of the NBRK's attorneys with completion of questionnaire titled, "Self-Assessment Questionnaire: FATF Special Recommendations on Terrorist Financing." The Ministry of Foreign Affairs sent this questionnaire to various Kazakhstani Ministries for completion. It seems the majority of this questionnaire was outside the realm of the NBRK, however, certain issues related to money laundering in general are applicable. The issues with ratification of UN Security Council Resolutions 1267, 1269, 1333, 1373, and 1390 are issues for the Ministry of Foreign Affairs and the Ministry of Justice.

The NBRK is working on issues related to money laundering, in general. However, the money laundering initiatives are not specifically focused on terrorism or terrorist activity. Kazakhstan has some fundamental issues to resolve regarding money laundering before it can reasonably proceed. First, the government cannot decide which Ministry or agency should properly take the lead for money laundering and financial crimes issues. This resulted in two draft laws on money laundering, one from the Financial Police and one from the NBRK. Kazakhstan apparently has formed a money laundering task force with representatives from the NBRK, Ministry of Interior - Financial Police, and Ministry of Finance - Department of State Revenue. Our project and representatives of the US Treasury visiting Kazakhstan in 2001 have supported formation of a committee system for money laundering and financial crimes issues to solve this problem.

Risk management. RA Stirewalt participated in a risk management conference, sponsored by the Kazakhstan office of KPMG, LLP. RA Stirewalt answered several risk management questions from a regulatory standpoint. Following this meeting, RA Stirewalt met on several occasions with representatives of Temir Bank in Kazakhstan to provide advice on risk management initiatives. In addition, as a result of new requirements regarding risk management stated in a letter from Deputy Governor Saidenov dated June 25, 2002, RA Stirewalt provided advice to the NBRK on risk management models.

RA Stirewalt prepared research and a summary paper for the BSD Methodology Unit on risks associated with offering Kazakhstan Depositary Receipts ("KDRs"). RA Stirewalt shared this advisory document with

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representatives of Pragma Corporation working with the Financial Sector Initiative to ensure a consistent message from both parties.

#### **E. Provide technical assistance within the scope of USAID technical assistance in Central Asia**

RA Stirewalt developed and delivered two program scopes for the “International Visitors Program – 2003”, sponsored by the US Information Service. The first program (Nov-2002) benefits banking and insurance supervisors, by allowing them to view on-site inspections of banking and insurance companies in the United States. The second program (May-2003) benefits one person from the NBRK in viewing the overall securities market operation in the United States.


RA Stirewalt assisted the Kazakhstan Community Loan Fund (KCLF) with development and delivery of a four-hour presentation to all loan officers of this microlending organization. The presentation included an overview of financial intermediation and the specific risks of managing a financial institution, a basic overview of accounting statements, and principles for sound credit risk management with an emphasis on microlending. Development of materials for this course consumed several days during June, with delivery of the lecture on July 1.

RA Stirewalt drafted an article regarding regulatory and supervisory developments in Kazakhstan relative to microfinance institutions to be included in a periodical issued by the Microfinance Center in Poland and discussed at the upcoming Microfinance Seminar in Budapest, Hungary in May. The article was published in the first edition of the “Policy Monitor”, July 2002. The Policy Monitor is published by the Microfinance Centre for Central and Eastern Europe and the New Independent States, sponsored by the Open Society Institute.

### **IV. PROJECT ACTIVITY WITH USAID AND USAID PARTNERS**

RA Stirewalt participated in each of the weekly USAID partners meetings and has actively sought opinion of other USAID partners as applicable. RA Stirewalt is particularly active with the Financial Sector Initiative, as these projects have considerable overlap. The following are illustrative of RA Stirewalt’s activity with USAID partners.

- RA Stirewalt shared information regarding deposit insurance activity with the USAID/Barents project at the National Bank of Kyrgyzstan. RA Stirewalt also provided a brief overview of deposit insurance, in written format and as a PowerPoint presentation, in Kazakhstan for various purposes within USAID.
- RA Stirewalt met with the Carana advisors and with the NBRK’s Deputy Chairman to discuss possible cooperation to develop a specialty area of accounting certification for bank accountants. RA Stirewalt met with ACDI-VOCA to discuss possible areas of cooperation with commercial bank and NBRK training needs.
- RA Stirewalt met with the Carana advisors and with the NBRK’s Deputy Chairman to discuss possible cooperation to develop a specialty area of accounting certification for bank accountants. RA Stirewalt met with ACDI-VOCA to discuss possible areas of cooperation with commercial bank and NBRK training needs.
- RA Stirewalt referred a large energy company to the Financial Protection Initiative team dealing with the securities market in Kazakhstan. The aforementioned energy company is exploring the issuance of subordinated debt in Kazakhstan.
- RA Stirewalt prepared a two hour presentation for USAID Washington personnel and delivered this presentation at USAID headquarters in Washington DC on December 14, 2000.

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- At the request of USAID/CAR, RA Stirewalt provided detailed input in the areas of creation of a Kazakhstan Development Bank and a government amnesty allowing repatriation of offshore funds into the Kazakhstan financial sector.
- RA Stirewalt met with the Executive Director of Nauryz Bank (purchased the insolvent AgriPromBank) to discuss possible technical assistance from USAID. RA Stirewalt referred the management of Nauryz Bank to ACDI/VOCA in this regard. Also, RA Stirewalt is attempting to arrange meetings for Nauryz Bank with the EBRD Small Business Lending Program and with the financial manager of Volvo's large equipment leasing program.
- RA Stirewalt delivered a two-hour presentation to Mr. Michael Fritz, Deputy Director, USAID Central Asian Region and to various senior management and foreign service national staff. The presentation was designed to highlight the banking supervision project, its history and various success stories as a result of assistance to the NBRK.
- RA Stirewalt participated in a round-table discussion sponsored by the American Chamber of Commerce with the US Ambassador to Kazakhstan, the Chief of Party of the Financial Protection Initiative, and members of the Kazakhstan business and political communities discussing "Improving the Investment Climate in Kazakhstan".
- RA Stirewalt provided assistance with development of a USAID-sponsored course entitled "Optimization of On-Site Practices", held in Warsaw, Poland. USAID and the National Bank of Poland have cooperated to form a regional training center near Warsaw, Poland. The National Bank of Poland has contributed the costs of the training center building, including housing and meals for participants. USAID has contributed funds for hiring a training center coordinator and bringing foreign experts as instructors and technical advisors to presentations. RA Stirewalt performed the role of technical advisor to several presentations prepared for Polish bank supervisors, and led several hours of the course instruction.

## **V. PROJECT ACTIVITY WITH OTHER DONOR ORGANIZATIONS**

RA Stirewalt has met with representatives from a wide variety of donor organizations over the period of the Project. RA Stirewalt has regular contact with the US Treasury, EBRD, EU Commission, IMF and World Bank representatives and various visiting delegations of these organizations. RA Stirewalt has also met on occasions with representatives of the Asian Development Bank.

## **VI. OBSTACLES TO SUCCESSFUL COMPLETION OF TARGETS**

We did not encounter any significant obstacles to the successful completion of this Project. All tangible results and benchmarks have been achieved. The BISD, and the NBRK, have been cooperative and welcoming to the technical assistance program. The BISD and NBRK management have not shown a great enthusiasm for on-site inspection assistance although they have not stated anything negative about this area of our technical assistance program.


The Director of the BISD for the majority of this Project (Mr. Arman Mekishev) is knowledgeable of financial regulatory issues. However, the Deputy Governors of the NBRK, in charge of banking supervision, possess stronger management and leadership skills. The Methodology Unit of the BISD is generally under-qualified for this role. This has slowed our technical assistance process at times, yet has not had a significantly negative consequence.

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**UZBEKISTAN - CENTRAL BANK OF UZBEKISTAN**  
**Final Report – Banking Supervision Assistance**

Contractor: Barents Group, LLC  
Task Order: OUT-PCE-803-99-00006-00  
Country: Uzbekistan  
Title of Task Order: Financial Restructuring and Financial Sector Accounting Reform  
Reporting Period: 3/31/00 to 9/30/02  
USAID COTR: Tatem, Lewis  
USAID COTR Office: Almaty, Kazakhstan  
Strategic Objective: 1.3  
Intermediate Result: 1.3.2

Prepared by David Hawkins, Resident Advisor  
James E. Horner, Managing Director  
Tina Mendelson, Advisor  
October 31, 2002

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## I. BACKGROUND

This report covers the progress of Barents Group assistance to USAID in relation to “Financial Restructuring and Financial Sector Accounting Reform in Uzbekistan.” The narrative discussion follows the scope of work requirements, and relates directly to the tangible results and benchmarks established for this project.

USAID has provided assistance to the Central Bank of Uzbekistan (CBU) since 1997. From April 1997 through February 2000, assistance was provided through International Business and Technical Consultants, Inc. and from March 1, 2000 to September 30, 2002, Barents Group provided assistance for improving bank supervision. The overall goal of the Project was to provide the CBU with assistance so that it could function as the primary bank regulator in a better and more efficient manner. To this end, USAID assistance was provided in Off-Site Supervision, On-Site Inspection Techniques, Corporate Governance, and Problem Bank Resolution.


Technical assistance provided by USAID through Barents Group advisors is described in this report in a chronological fashion. The initial phase (Phase I) of technical assistance dates from March 2000 through September 30, 2000, Phase II from October 2000 through March 31, 2001, Phase III from April 2001 through July, 2001, Phase IV from September 2001 through January 2002, and Phase V during August 2002. The specific, approved scopes of work for each phase of this Project can be found within the narrative text of this report, Section III.

## II. UZBEKISTAN – PROJECT SUCCESS STORIES

During this Project, our advisors have contributed to many significant accomplishments that will have direct consequences for the financial sector development in Uzbekistan. However, assistance ended in January 2002, after it was determined that more progress on economic reform was necessary if assistance were to continue due to weak economic progress. Only during first half of 2002, there were some signs that reform may be taking place. The Government agreed to a six-month Staff Monitoring Program (SMP) with the IMF, and the IMF Mission in June 2002 confirmed the Government's compliance with targets set out in the SMP. As a result, USAID/ Barents provided some limited assistance during August 2002 in the area of foreign exchange.

In sum, while Barents/ USAID assistance in Tashkent was not as extensive and continuous as in Kazakhstan, we were able to achieve several significant accomplishments, including:

- Off-Site Supervision Institutionalized and Made More Efficient – As a result of the work that was finalized during the tenure of this project, off-site supervision at the CBU was well institutionalized and operating independently with minimal assistance from RA David Hawkins. The CBU Off-Site Division was able to receive information from banks, process it, provide output reports to analysts, and use the information generated to identify problems at Uzbek banks. This was considered a success in that it was the one area in the BSD that was self-sustained.
- Elimination of 30 day-limitation on bank inspections – This limitation was initiated by another USAID project and unintentionally included banks in the Presidential Decree that was trying to reduce the amount of governmental interference at companies in Uzbekistan. The Decree required all governmental agencies that have supervisory authority over companies to limit the amount of time spent at inspections of companies, and thus banks, and severely limited the CBU's authority to supervise banks. With the safety and soundness of the banking system in mind, and in order to protect depositors, the bank regulator must be able to inspect banks at will

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and to act independently when doing so. As a result of the persistence of the CBU, through RA Hawkins, the CBU was finally able, after at least two years of operating under the authority of the Decree, to eliminate itself from the limitations outlined in the Decree. The result was that the CBU could operate more independently and was more closely in compliance with the Basle Core Principles for Banking Supervision.

- Report Writing Vastly Improved – Prior to the initiation of report writing workshops taught by RA Hawkins, the report writing was unsatisfactory. Inspection reports were not being written clearly, had factual errors, and in general, were not useful to the reader of the report. RA Hawkins provided several report writing workshops and as a result of these workshops, the report writing improved considerably.
- The issuance of accounting pronouncements is now centralized in the Accounting Methodology Department under the Chief Accountant. Further progress has been made towards an enactment of the tax reconciliation regulation (reconciliation of accounting income to taxable income).

### III. SUMMARY OF PROJECT ACTIVITY

#### PHASE I – MARCH 2000 THROUGH SEPTEMBER 30, 2000


##### A. Assist the CBU with On-Site Inspections

Early in the project, RA Hawkins met with the Acting Vice-Chairman for Bank Supervision, Mr. Jumaev, to discuss the needs of the CBU. Mr. Jumaev indicated that it was most important to focus assistance on the On-Site Inspection Department, and secondarily, to the Off-Site Department. The main problem seemed to be lack of leadership from the director of the On-Site Department. In total, at that time, there had been four directors since the project commenced in 1997. RA Hawkins further requested, and Mr. Jumaev agreed, that the training team concept be reinitiated at the CBU. This concept worked well previously and would provide some continuity from inspection to inspection. In addition, the inspectors on the training team would be expected to train other employees on the concepts that were learned.

During this Phase I of the project, RA Hawkins assisted with on-site inspections of six banks:

- In March, RA Hawkins provided assistance for the completion of an inspection report for a large bank, including assistance in the area of accounting for additional provisions for losses required as a result of the inspection (and the resultant affect on bank capital).
- In April, RA Hawkins provided assistance at an on-site inspection with the training team inspectors. RA Hawkins provided training on credit analysis, work papers and inspection documentation, reporting requirements, and audit requirements. Information was also provided to the internal auditor of the bank on how to improve the internal audit program. The inspectors were still having some difficulty in classifying assets properly. This problem was partially attributed to a regulation that was not entirely clear and partially to a lack of experience with classifying assets. As this was one of the banks that were to receive direct assistance from the World Bank advisors, the information that was obtained at this inspection was considered to be extremely useful in identifying areas that needed to be improved, thus acting as a diagnostic tool for the other advisors to use. RA Hawkins attended a meeting with Arthur Andersen, the external auditors for this same bank. The accountants indicated that the audit would be presented according to IAS (as agreed with the World Bank and the CBU), and that differences between IAS and Uzbek Accounting Standards would be identified and provided to the bank. The auditors



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would also be expected to assist the bank in making their adjustments and in editing the year-end Call Report that was previously submitted to the CBU.


RA Hawkins noted the on-site inspectors have difficulty with report writing and he provided written instructions on how to complete a report comment. These written instructions were mainly provided to assist them in their writing format, and not in the content; however, assistance was provided during the inspection on content also. Much of the time was devoted to classification of assets and assessment of risk.

- In June 2000, RA Hawkins provided feedback to the CBU management on the inspection process for a bank inspection completed in the early part of the month. The feedback letter provided a summary of the assistance during the inspection, and an assessment of the work of the inspectors and of the inspection report itself. Feedback provided included the following:
  - The inspectors were beginning to have a better understanding of how to classify assets and what to look for in a loan file;
  - Report writing continued to need improvement;
  - Although a specific format was provided to the inspectors on how to write the "Overall Conclusions" comment, the comment was not sufficient. RA Hawkins developed and delivered a basic report-writing course in an attempt to alleviate this problem.
- In June 2000, assistance was provided at an inspection of a large state-owned bank. RA Hawkins provided assistance on an ad-hoc basis for this inspection. A member of the local staff worked directly on this inspection on a daily basis and provided comments and feedback to RA Hawkins regularly.
- In August 2000, feedback was provided to the CBU management on the inspection process for a bank inspection that was completed in July. The letter provided a summary of the assistance that was provided during the inspection, and an assessment was made of the work of the inspectors and of the inspection report itself. Feedback provided included the following:
  - The inspectors continued to have problems with report writing and with summarizing their observations into logical, written, conclusions;
  - In general, the report had many facts but would have been more useful with more assessments and conclusions. Only one CAMEL area had an assessment (Liquidity). We had previously taught the inspectors that each comment could be improved with both an assessment and a conclusion (i.e. each CAMEL area must be assessed as either good, bad, satisfactory, unsatisfactory, etc., and a conclusion should be provided at the end of each comment). The report writing skills continued to need improvement and RA Hawkins suggested that these.

In August 2000, the Director of On-Site Inspections responded, in writing, to this feedback. The contents of the response indicated that he was appreciative of the feedback that was provided and that he would take measures to ensure correction. Further, he requested continued assistance in this area which was a great step forward compared to his initial lack of interest in the project.

- In September 2000, RA Hawkins assisted on-site inspectors with completion of an inspection site of another large state-controlled bank. The CBU Inspection Department provided a full-time counterpart to work with RA Hawkins. The CBU counterpart was asked to work with the on-site inspection procedures to improve them and to make recommendations for additions to them.

RA Hawkins and his staff also provided assistance in the drafting of the written strategy to eliminate the 30-day inspection limitation on bank inspections. Although still somewhat general, Mr. Hawkins worked

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directly with the CBU (BSD and CBU's Chief Counsel) to take some tangible steps to correct this problem.

**B. Assist the CBU with Off-Site Surveillance**

RA Hawkins made a recommendation to Mr. Jumaev that the analysts only perform an extensive review of the banks on a once-per-quarter basis, rather than once per month. This did not mean that the analysts would only be able to identify potential problems on a quarterly basis, but meant that they would do a full analysis of the banks, based on the Bank Performance Reports that are generated for each bank, on a quarterly basis. The analysts were still responsible for doing some analysis on a monthly basis. RA Hawkins developed a new internal report for the analysts to use in their analysis. Previously, the analysts were required to complete two forms, and some of the information was redundant. This new form was considered to be less time consuming to complete, and each of these recommendations improved the efficiency of supervisory processes.


RA Hawkins also provided training sessions to further the analysis skills of the off-site analysts, in such areas as the meaning of certain ratios and how to calculate certain ratios. A practical exercise whereby each analyst was required to fully analyze a bank, present their conclusions to the other participants, and make recommendations was also part of the training. Many of the analysts were new at the time (hired in 1999) and they were still learning many of the concepts. In addition, training was provided on how to complete the new internal report that was developed by RA Hawkins. The analysts indicated that the training was very useful, especially the practical aspect of it.

RA Hawkins also provided feedback to the off-site staff on their analyses of banks for the March quarter-end. Individual, rather than group, sessions were held. The analysts did a much better job than in the past, with regard to both the analyses and in completing the forms correctly. Out of the eight off-site analysts, seven were performing at a satisfactory level and only one was performing at an unsatisfactory level. Already by July 2000, the BSD staff was able to run the June Quarterly Bank Performance Reports with little or no assistance from RA Hawkins or his staff. This was significant as this was a first time occurrence. Our Project continued to run the system in parallel with the CBU's system so reports in English were available and so that we could verify that their reports have been run correctly. No significant differences were noted.

RA Hawkins assisted the CBU with the development of specific instructions on the surveillance system. At request of RA Hawkins, Mr. Jumaev appointed two additional staff members to learn the operations of the surveillance system. This was to help protect the CBU and the system in case of staff attrition. Further, RA Hawkins and his staff provided assistance to the staff of the CBU to add a new bank to the database of the off-site surveillance system and to remove a bank that was merged with another bank. This was a good exercise and the CBU staff derived a new way to make the changes that saved a great deal of time.

In June 2000, the systems manual prepared by RA Hawkins for the off-site system was formally provided to the CBU for review and approval. In response to this submission, Vice Chairman Rofiev sent a letter to RA Hawkins indicating that he approved the manual. In this letter, he also requested assistance with adding new accounts (from the Chart of Accounts) to the Call Report instructions so that the banks would know on which lines to include these new accounts. In August 2000, RA Hawkins provided an amendment to the current Call Report Instructions to include new accounts that were added to the Chart of Accounts in July.

RA Hawkins provided an analysis of the banking system to bank supervision management that identified significant trends and other items warranting their attention. There were still some problems noted with the accuracy of reporting. The chief problem stemmed from the failure by many banks to establish

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adequate reserves for loan losses. This resulted in an overstatement of capital and net income. In addition, some banks had paid dividends even though reserves had not been established. These items were discussed with Vice Chairman Ropiev and he promised that they would clear up this problem in the near future. It was also included as a specific benchmark for the CBU to achieve before the end of the year.

In September 2000, the majority of the off-site quarterly reports from June were received. The amount of time it took to receive these reports indicated that, for this quarter, the system was not working as an "early warning" to potential problems as well as it has in the past. The lack of timely reporting was discussed with the Deputy Director, Ilkholm Mustafaev, and he indicated that many of the reports were late due to summer vacations. He indicated that this would be corrected in the future. Along these same lines, Mr. Mustafaev asked specifically for management coaching to be provided to the manager of the department. RA Hawkins suggested a need for more on-the-job training and supervision by the off-site manager and that the program would be more successful if this were to occur. Mr. Mustafaev agreed and, as part of the coaching RA Hawkins included these areas in the new work plan to the extent possible.

**C. Provide Additional Training as Warranted at the Request of the CBU**


In June 2000, a one and one-half day writing seminar was provided for the on-site inspectors. This was in response to the continued need for improvement in the way reports were being written. Approximately 22 inspectors attended the seminar. Practical exercises were provided during the seminar and two report comments from an ongoing inspection were provided to the group for review. Participants then determined how the comments should be changed to present the information in a clear manner and to eliminate information that was not pertinent.

In September 2000, RA Hawkins delivered a test to the BSD staff on basic skill sets. The test was intended to determine the general knowledge of the BSD staff on very basic regulations and inspection procedures (the inspection procedures test was only provided to the On-Site Department). The average score on the test was low with only a few exceptions. In response to this test, RA Hawkins and his staff identified some regulations that were essential for good bank supervision and that need to be taught further. The test indicated that additional training should, as a priority, focus on five regulations: Capital Adequacy, Loans to Affiliates, Large Loans, Factoring and Accounts Receivable Financing, and Financial Leasing. In response to these results, formal training was provided to the CBU BSD staff on the Factoring and Accounts Receivable Financing and additional training was provided on an on-going basis.

**D. Assist the CBU with General Advice on Basle Core Principles**

RA Hawkins devoted significant time to developing a review of the Basle Core Principles for Banking Supervision. This was developed at the request of USAID-CAR and was intended to be used to check the progress of the Bank Supervision process on a periodic basis. This review, although not as extensive as a formal, independent Basle Core Principle review, revealed that there were many areas that needed improvement and many weaknesses in the structure of the regulatory system. Most important of all was the significant lack of independence of the CBU. In many cases, there was a general framework for effective banking supervision but no practical effort. The following four areas indicated that there was no compliance and no effort being made to ensure compliance:

- a lack of legal protection for supervisors,
- a lack of policies and procedures for identifying country risk,
- a lack of accurate measures for controlling market risk, and
- a lack of "know your customer" rules to alleviate money laundering and other criminal activity.

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There was also no real effort to supervise the banking groups on a consolidated basis; however, this was not as crucial as the other areas as there were no real activities of banks at this time besides those that are at the banks themselves and not at affiliates. There were reportedly no "non-bank" banks at this time or insurance or other relevant subsidiaries of banks. Some areas were considered to be satisfactory, including:

- a suitable legal framework for banking supervision relating to banking supervision and their ongoing activities,
- the use of the word "bank" and the licensing of banks and their permissible activities,
- and the CBU's reported practice of global supervision and maintaining correspondence with host country supervisors.

These results were shared with Chairman Mulladjanov and his management staff with the hope of furthering communication to CBU management on areas needing improvement.

#### **E. Provide guidance on Problem Bank Supervision techniques**


In April 2000, RA Hawkins assisted the CBU with a problem bank situation. The CBU approved a request from a problem bank to voluntarily liquidate the bank. The CBU had requested a merger with another bank, but the shareholders requested that the bank be allowed to liquidate.

In August 2000, RA Hawkins expressed concern to the new Vice Chairman, Mr. Rofiev, that the CBU had been deficient in following the guidelines developed with the assistance of the USAID Advisors and approved by the CBU Council. The BSD had not been transferring banks into the Problem Bank Unit even when they met the definition of "problem" according to the guidelines. Mr. Rofiev indicated that this problem would be corrected. It was also listed as a tangible benchmark for the CBU to meet by the end of the year.

#### **F. Coordinate with the World Bank and IMF advisors**

During the Phase I of the project, RA Hawkins established a cooperating relationship with the World Bank and IMF advisors. Select examples of such cooperation include:

- RA Hawkins and a World Bank advisor met on several occasions regarding a bank that is currently under inspection with which the World Bank is providing assistance. The World Bank advisor also attended the meeting with the external auditors at the conclusion of the inspection process. RA Hawkins provided additional assistance to this advisor throughout the month including a list of potential accounting errors or CBU reporting errors.
- RA Hawkins and Michael Crossley, an advisor on a World Bank project, met on several occasions to discuss the interpretation of an external audit regulation that was introduced the previous year by the CBU. The regulation required that all banks submit amended year-end information to the CBU when the results of their audits were made available. The effect of this regulation was that certain bankers were instructing auditors not to make some of the audit adjustments that were recommended by the external auditors. Not only was this a direct contradiction to the regulation, it would mean that the Call Reports being filed were not correct, mainly by overstating capital and understating reserves.
- A meeting was held with a consultant on the World Bank project that was providing assistance on payment systems.
- RA Hawkins provided information on corporate governance of banks to a World Bank representative in Uzbekistan reviewing this area.
- RA Hawkins attended a meeting held between the World Bank advisors, Arthur Andersen and Price Waterhouse Coopers. The meeting was held to discuss the content of a report that was

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required by the World Bank and that provided an overall summary of the problems in Uzbekistan and potential solutions.

- At the request of the World Bank project, RA Hawkins planned and chaired a meeting that was held with foreign consultants and representatives of the CBU. This meeting proved beneficial in that it allowed participants to identify what other issues consultants were working on. The overall goal was to hold these meetings on a regular basis, perhaps twice a month, so that there would be coordination among the projects and duplication of work could be avoided. It also allowed for the attendees to discuss and resolve specific problems that were impeding progress in projects. As a result of the first meeting between the NBKR consultants, the participating consultants drafted and signed a request to Chairman Mulladjanov to share information among the donor projects. This was expected to help the projects become more efficient and to help change the past mindset of the CBU BSD to require control over all information to be shared, i.e. general transparency should be improved. Chairman Mulladjanov had agreed to meet with all consultants on this issue. This was a definite breakthrough and a very positive action.

#### **G. Other Items Relevant to the Project**

RA Hawkins provided comments to Mr. Jumaev regarding the following three new decrees and resolutions that were translated by Barents staff:

- A Presidential Decree "On measures for further liberalization and reforming of the banking system." This decree outlined the measures that must be formulated by the various Ministries and other bodies to improve banking reform in the country. One provision stipulated that individual depositors do not have to disclose the source of their funds that they are depositing. This was an important step in that, at the time, people thought that it bring more deposits into the banking system. The creation of Deposit Insurance was also mandated. The Decree also allowed certain tax advantages to banks that provide credit to small and medium enterprises, thus trying to stimulate small business lending. For the most part, this decree was considered a positive step for Uzbekistan.
- A Resolution from the Cabinet of Ministers titled "On additional measures for the development of off-exchange currency market." Its purpose was to strengthen and further develop the off-exchange currency market ("curb market"), to prevent the violation of the current legislation on the cash currency exchange, and to improve the mechanism of paid services provided by enterprises to nonresident individuals. In short, the document specified that payment for many services by nonresident individuals must be made in a freely convertible currency.
- A third document was the most relevant for banking supervision and banking reform, as it outlined the actual program that was requested in the aforementioned Presidential Decree. This program required all banks to increase their authorized (paid-in) capital by allocating retained earnings to that account, thus making them unavailable for dividends. It also recommended that management of banks increase corporate governance, and for them to receive mandatory reports on the condition of their bank on at least a quarterly basis. It provided a manual for the banks with direct state ownership of more than 50 percent (5 banks total) to use. The program called for further privatization and denationalization of banks, an increase in the quality of bank management and in the training provided to bank personnel, restructuring of problem assets through a "banking assets restructuring agency," the development of a credit information bureau for the provision of credit histories of potential borrowers, and an elimination of the tax committee's reliance on banks to perform certain tax roles (which most certainly kept many citizens from depositing funds in banks). The program also indicated the need for new textbooks, manuals, and other literature so that they followed international standards.

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Currency Convertibility Issues. In April 2000, the Cabinet of Ministers issued a resolution that stated that its purpose was to further "deepen" the process of liberalization of the foreign exchange markets, optimize the accounting and reporting of foreign exchange transactions and the calculation of tax payments and settlements on export and import transactions. This resolution reportedly eliminated the CBU rate as the official rate for such transactions, choosing instead the higher commercial rate as the standard, thus unifying the two rates. RA Hawkins considered the effect that this resolution might have with the minimum capital requirements. Banks were currently required to have a minimum capital requirement of US\$300,000, US\$2,500,000, or US\$5,000,000 in addition to other capital requirements (for example, 10 percent regulatory capital to risk-weighted assets). Unifying the difference between these two rates (the CBU rate of 150 soums per USD vs. the commercial rate of 231 soums per USD), would mean that banks must have more soums in their capital accounts to meet the US dollar capital requirements.

In June 2000, there was continued talk of a possible loosening of the convertibility restrictions in Uzbekistan, but no action had been taken. At best, it appeared that the government might be willing to allow partial convertibility for individuals (not companies) so that they may exchange soums for dollars. In other words, the government might allow some exchange windows to be opened. The amount of soums that could be exchanged was expected to be limited and the speculation was that it would have little effect on merging the exchange rate of the black market with the official exchange rate. However, it would most likely bring the two exchange rates closer together. At the end of this month, the official exchange rate was 255 soums per US dollar vs. 680 soums per US dollar in the black market.


In July 2000, the Government took two more steps toward liberalizing the country's currency controls. This process began in May, when the Resolution was adopted that combined the country's two official exchange rates into one unified rate. Two additional resolutions became effective on July 1 that continued this process of reform. The impact and scope of these Resolutions were considered very modest. They did provide the first instances (although limited) in which the local currency could be converted into and from hard currency at approximately a market rate.

Under the first Resolution, banks could purchase (but not sell) hard currency from their customers, on a contractual basis, at a free exchange rate. While this would not help investors with soum income from Uzbek operations, it would help those that had soum expenses since they could not, at the time, legally purchase soum at a free exchange rate. Additionally, this resolution limited the amount of advance payments that could be made under import contracts to 15 percent of the contract with a maximum \$100,000 aggregate limitation.

The second of the two Resolutions applied only to individuals and not to legal entities. It allowed for the residents of Uzbekistan to purchase up to \$300 at exchange booths for travel outside of Uzbekistan. Residents traveling abroad were also allowed to take out \$5,000 without approval, whereas the previous limitation was \$1,500. Non-residents were allowed to reconvert into hard currency the unspent portion of any local currency that was officially obtained from a local exchange booth. One of the criticisms of this Resolution was that only 4 banks (all with either state-ownership or heavily controlled by the state) were allowed to participate by selling dollars for soums. Other banks could only purchase hard currency.

## **PHASE II – OCTOBER 2000 THROUGH MARCH 2001**

### **A. Assist the CBU in developing a strategy for the amendment to the 30-day limitation on inspections**

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In October 2000, RA Hawkins provided information to the CBU that outlined the reasoning behind the need for the repeal of this provision. During the month, the CBU's First Vice Chairman sent a letter to the Cabinet of Ministers requesting that this provision be repealed. In November, the CBU received a copy of a response from the Ministry of Justice that, in effect, stated that the CBU should adhere to the 30-day limitation. The reason for this was not provided, except to state that the CBU should follow the act that was previously enacted that established the limitation.


RA Hawkins made additional recommendations to Chairman Mulladjanov, highlighting international standards and practices. As a result, Mr. Mulladjanov requested the Cabinet of Ministers for a waiver to the 30-day limitation rule. In February, the CBU reported that it was successful in its request to remove the CBU from the list of "controlling entities" and by March 2001, the 30-day limitation on inspecting banks was lifted. According to the CBU, that was the final step that ensured that the CBU's inspection schedule would not be subject to approval from any entity outside of the CBU. This was a highly positive step that the advisors had been attempting to remove since it was enacted in 1998.

During the same period, RA Hawkins also prepared a recommendation memo to Chairman Mulladjanov regarding the need for independence of the CBU. This memo was prepared in response to a request from the Cabinet of Ministers that the CBU reduce the number of overall inspections at the banks and to make the inspections "more efficient." Although there was a need for the inspections to run more efficiently, there was no sound reason for reducing the number of inspections at the commercial banks. RA Hawkins recommended to the Chairman that the CBU should continue to inspect banks at least annually. One argument provided by RA Hawkins was that the overall cost of resolving problem banks would be reduced when inspections are performed frequently. This was a result of the regulator being able to more frequently identify and correct problems. RA Hawkins also reiterated the need for the CBU to be able to operate without outside influences and to gain more independence. While this independence is stipulated in law, it was not used in practice.

## **B. Assist the CBU with development of a seminar on the topic of corporate governance of commercial banks**

During this Phase II of assistance, RA Hawkins assisted with several seminars on corporate governance:

- In October 2000, at the request of the Chairman of the CBU, the FSDA/World Bank project managers requested that one of the Arthur Andersen advisors provide a corporate governance seminar in the near future. RA Hawkins met with the advisor to provide the new Regulation on Corporate Governance and to provide advice regarding the intended participants.
- RA Hawkins participated, on a limited basis, in three workshops presented by the ADB. One workshop was for commercial banks where RA Hawkins' speech was based on the CBU's role in ensuring good corporate governance at banks. An additional workshop was provided to some CBU staff members where RA Hawkins discussed what the CBU needs to do to improve its own corporate governance. The third workshop was for commercial banks where RA Hawkins discussed corporate governance and the current problems resulting from the relationships between the government, the CBU, and certain commercial banks.
- In November 2000, a two-day seminar was provided on corporate governance for Council members of the commercial banks, CBU staff members, and other commercial bank staff members. RA Hawkins assisted provided considerable information on the subject to Director of Licensing and Bank Regulation Abdullaev which he used for his introductory speech. The speech was surprising in that he indicated to the participants that bank management and Council members had performed poorly in the past with regard to Corporate Governance of banks and

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that vast improvements were needed. He pointed out specific examples of how banks were not practicing good Corporate Governance and said that the CBU would be looking very closely at management issues and would hold the Council members responsible for problems at their banks. In a meeting after the speech, Mr. Abdullaev indicated that he was in favor of establishing a means whereby the CBU could hold a member of management personally and directly liable for any serious problems noted at the banks. He requested assistance with regard to this and asked for guidelines on establishing civil money penalties in Uzbekistan. RA Hawkins later provided assisted with this area.

### **C. Assist the CBU with On-Site Inspections**


An initial evaluation of the on-site area indicated that the inspectors, in general, had a relatively sufficient understanding of the regulations and safe and sound practices. The concern continued to be with the inability of the inspectors to formulate their opinions and to commit them to writing in a conclusive manner. Lack of organization with regard to inspections was also a problem. These are areas that had been a problem since the beginning of the project in April 1997. RA Hawkins requested that a staff member of the CBU's BSD, who had recently returned from completing a Masters program in England, be allowed to help in this area.

As mentioned earlier in this report, the full-time CBU counterpart was assigned to work exclusively with our Project on on-site issues and to assist with the implementation of goals. In October 2000, the CBU counterpart was responsible for the adoption of two tangible benchmarks, including the review, evaluation and revision of current inspection procedures and assisting with the development of some of the training materials used to train the on-site staff. RA Hawkins and his staff members worked closely with this counterpart to further improve the overall inspection process and to ensure sustainability of the core knowledge sets after the Project termination.

During this period, RA Hawkins and his local staff participate in the preparation for and implementation of several inspections:

- In October 2000, an on-site inspection of a foreign-owned bank commenced. Although the CBU had been instructed to enter the bank in early October, the staff was not prepared to enter the bank as little preliminary planning had been performed prior to that time. In order to plan properly for the inspection, and to provide training on how to plan for future inspections, RA Hawkins requested that the inspectors not physically enter the bank until the preliminary work had been completed. This request was approved. The preliminary work that was needed included general organizational work (such as staff planning) and meeting specifically with off-site analysts to discuss the bank's recent trends and potential problem areas. In addition, RA Hawkins instructed the Examiner In-Charge (EIC) how to review certain documents that were available at the CBU, such as the external audit reports, the most recent Call Report, and any correspondence that was received by the CBU or had been sent to the bank since the previous inspection.
- In November 2000, RA Hawkins provided assistance for the completion of an inspection of a joint-venture (foreign-owned) bank. Much of the assistance was provided to improve the organization of the inspection, including the need for work papers to support conclusions. This would help make the inspections much more efficient in the future.
- In December 2000, an inspection commenced with RA Hawkins' assistance. The assistance centered on properly organizing the inspection prior to entering the bank and meetings were held with the EIC to teach the specific actions to be taken prior to commencing the inspection.



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- In January 2001, two inspection reports were reviewed and feedback was provided on the analysis and the report writing. Both the analysis and the report writing continued to improve but deficiencies remained. RA Hawkins continued to work with the CBU inspectors in these areas.
- In February 2001, work commenced at an on-site inspection of a state-owned bank. RA Hawkins assisted in the preplanning phase of the inspection and in the inspection itself. Workshops were provided to the inspectors at this particular inspection on topics covering Investment Securities, Accounting for Investment Securities, and Classification of Investment Securities. Additionally, training was specifically provided to the inspectors regarding Repossessed Assets and Other Assets and their classification. A one-day training seminar on report writing was held in mid-February for the on-site inspection staff. The seminar allowed the participants to have the opportunity to review an inspection report that the staff had recently completed.
- In March 2001, RA Hawkins assisted in the preplanning phase of another inspection and in the inspection itself. Assistance was provided to the inspectors in the areas of Investment Securities and Classifications, Classification of Assets, Related Party Transactions, and Capital. In addition, assistance was provided on Direct Lease Financing as this bank was more experienced with leases than most of the banks we had previously worked in.

Training. RA Hawkins also provided training in four areas, including Asset Classification (2 sessions), Capital, Affiliated Party Transactions, and Large Loans. Although all supervisory staff was invited to attend, it was chiefly attended by on-site staff, including the Director. This was a marked change from training provided in the past, and there appeared at the time to be a new interest taken in the project by the CBU BSD.

In March 2001, a one-half day workshop on report writing was held and was very successful compared with those in the past. In the past, the workshops had used reports that were previously written and had already been sent to the commercial bank. In this particular workshop, the draft report for the bank inspection that had only recently been completed was used. As this report had not been finalized by the Inspection Department yet, the participants were able to offer suggestions on how to improve the writing, including format and content. It was encouraging to see that for the first time, three of the five report comments for CAMEL components were written with very little revision needed.

Finally, RA Hawkins provided specific advice on on-site policies and procedures, including:

- Efforts were made to have inspectors develop a standard to classify government-directed loans that are also guaranteed by the government. With this standard, RA Hawkins recommended that such loans be classified at a minimum "standard" with a required 10 percent provision. The rationale for this classification was based on the fact that the bank was not doing proper underwriting of these loans and that we should treat these state-owned or highly state-influenced banks as any other bank in looking at the way they do business and in assessing the risk. However, although RA Hawkins provided a specific way to classify assets the CBU declined to utilize this and chose instead to consider all government-guaranteed assets as "good."
- RA Hawkins also developed a sample of a pre-examination request letter. This letter, if adopted, would allow the CBU to request that certain information be ready for review upon inspectors entering the bank. Under current guidelines, the CBU would not begin to request information until entering the bank, and there was a delay in starting the inspection as a result.
- RA Hawkins provided feedback to the CBU on the procedures that it adopted for use in the inspection process. Overall, the procedures were good and were not in conflict with the specific inspection procedures being used by the CBU staff. A suggestion was made that the procedures be amended to include the need for maintaining adequate working papers and that

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specific timeframes for the completion of reports should also be included. This was especially important as the processing time had not been well defined, which resulted in a high possibility of the information becoming outdated.

- RA Hawkins recommending instituting a formal accreditation process for inspectors. Vice Chairman Rofiev agreed in principle to the program, but wanted to look at the proposal more closely. Although the CBU tested the knowledge of bank inspectors on an annual basis, the testing was not standardized and all persons took the same test, regardless of their level. The accreditation program proposed was three-tiered and would improve the current process.

#### **D. Assist the CBU with Off-Site Surveillance**

RA Hawkins analyzed the conditions in the banking sector based on the September 30 Call Report. Early indications were that some improvement was noted in the accuracy of the reporting to the CBU, as only seven banks were reporting inadequate reserves for probable losses as opposed to sixteen at the end of the second quarter. The analysis does indicate that the CBU had taken action with regard to certain problems noted in the past, such as the failure by some banks to establish adequate reserves for loans and other losses.

RA Hawkins reviewed a new form that the CBU wanted to include in the Call Report. This report page provided a breakdown of a bank's loans by sector and client and indicated whether the loans were denominated in national or foreign currency. In addition, this report further breaks down all categories so that a determination could be made as to which of the loans were guaranteed by the Ministry of Finance. The fact that the CBU initiated the addition of this report page to the Call Report indicated a change from the past and was considered a positive step. This information would be useful to see the overall exposure of the government in area of bank loans.


RA Hawkins also provided an assessment of the banking industry to Vice-Chairman Rofiev using information as of December 31, 2000. RA Hawkins identified areas that needed improvement if the banking supervision function was to move ahead and if there was any chance for privatization. Issues discussed included the lack of an independent CBU, the interference by the government into the banking system, the failure to determine what to do with problem assets at banks scheduled for privatization, and other such issues.

Finally, RA Hawkins reviewed edits to the Call Report and Instructions and found no significant problems. This area continued to operate mostly autonomously; however, a request was made that ratio analysis training be provided to the new employees of this department. A change was also made to the Bank Performance Report system based on the edits made to the Call Report. These changes were made by the CBU staff after RA Hawkins's review.

#### **E. Provide Assistance in the review, development, and implementation of regulations**

RA Hawkins discussed with representatives of BSD and the World Bank project the Classification of Assets regulation. As a result, a recommendation was made to provide separate classification regulations for loans and for assets other than loans. He also provided three different workshops during which he discussed the current Capital and Asset Classification regulations and the problems inherent in trying to use them at the time. There were many items in the regulations that needed to be amended to make them clear and less ambiguous.

RA Hawkins also provided direct assistance to the BSD Director on improving the capital regulation. Changes that were suggested included the transfer of net income to tier I capital. In addition, devaluation reserves would also be moved to tier I capital. The First Vice Chairman of the CBU made a decision to

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continue to include current year earnings in Tier II Capital (normally this is in Tier I Capital). He considered this to be a conservative approach, but the decision lacked sufficient rationale, as the current year earnings became a part of Tier I Capital anyway at the end of the year (as retained earnings) even though there is no real change in the “quality” of the earnings. RA Hawkins also provided specific wording on requirements of a capital plan that must be submitted by a bank to the CBU once a bank fails a capital requirement.

Finally, RA Hawkins provided assistance to the CBU Securities Department on the feasibility of banks engaging in reverse repurchase transactions with counterparties that use either treasury or authorized but unissued stock to effect the transactions. As a result of this review, a recommendation was made that the regulation be improved so that this practice would be specifically declared unsafe and unsound and not allowed by the CBU.

#### **F. Provide Additional Formal or Informal Training as Warranted**

RA Hawkins performed an examination of some of BSD staff members on their knowledge gained from previous seminars. The results indicated that the On-Site inspectors were much more knowledgeable about CBU regulations than the Off-Site staff. However, there was still a need for training in all areas of Banking Supervision for all members of the BSD. Although only nine out of twenty-two participants received a score of 70 percent or better, RA Hawkins still considered this to be an improvement over past results and considered it a better indicator of knowledge as the test was short-answer essay and not a multiple choice format.

As a result, a bank simulation-training course was provided to 8 participants from the CBU. This course, which was provided at the Regional Bank Training Center, was considered a success. This training was provided with USAID funding and was facilitated by Global Training. The main goal of the training was to provide instruction on what effect certain operations taken by banks would have on the financial performance of banks. Another bank simulation course was provided to participants from the CBU and commercial banks. It was held at the Regional Bank Training Center, and received positive feedback. In all, 50 participants were trained.

Two training courses on report writing were provided by RA Hawkins. The participants were provided with an actual report comment and asked to critique it based on guidelines that were previously provided by RA Hawkins. This was a more practical, rather than theoretical exercise, and, as a result, most participants said that the courses were beneficial.

Finally, RA Hawkins delivered a presentation on Corporate Governance at the Presidential Academy.

#### **G. Provide guidance on Problem Bank Supervision techniques**

In October 2000, RA Hawkins discussed the problem of the BSD not following CBU guidelines with regard to transferring problem banks into the Bank Resolution Unit with management of the CBU. A month later, one bank was formally transferred to the Bank Resolution Unit, bringing the total number to three. RA Hawkins and the inspection staff recommended that the joint-venture bank that was recently inspected be transferred to the group for closer supervision. During the meeting with Director Abdullaev, RA Hawkins provided advice on how the CBU should proceed with this particular bank resolution process.

By February 2001, RA Hawkins recommended the transfer of two additional banks to the Problem Bank Unit, of which one was a “5” rated bank. Mr. Hawkins became aware of this bank’s rating during the

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month and according to the CBU policy, this bank should have been transferred to that department. The CBU promised that this bank would be transferred after the current ongoing inspection.

#### **H. Coordinate with the World Bank and IMF advisors**

As during the previous phase of this project, RA Hawkins actively engaged in discussions and cooperation with the World Bank and IMF advisors. Some of the example include:

- In October 2000, RA Hawkins participated in one meeting with a World Bank advisor to discuss Corporate Governance. In addition, meetings were held with members of the CBU working on the World Bank project to discuss accounting practices and problems, and to discuss the findings of the Basle Core Principle Review.
- In November 2000, RA Hawkins provided relevant information on banking sector to an IMF and later IFC missions in Tashkent.
- In January 2001, RA Hawkins met with Christof Rosenberg, Country Manager for the IMF. He stated that the IMF was still planning to close its project in April, leaving only a shell office that would primarily be responsible for receiving economic information.
- Various meetings were held with advisors from the World Bank project. RA Hawkins provided assistance on reviewing a new Basle Committee pronouncement on "Best Practices for Credit Risk Exposure."

#### **I. Other Items Relevant to the Project**

Information sharing among donors. In October 2000, a meeting was held with Chairman Mulladjanov to discuss the sharing of information among the various donor projects. The outcome of this meeting was positive in that the Chairman indicated that it was in the best interest of the CBU for consultants to cooperate with each other. A draft Confidentiality Agreement was previously developed and was under review at that time.

Basle Core Principles. In October 2000, results of the Basle Core Principle Review were shared with Chairman Mulladjanov and his staff. As a result, RA Hawkins met with the Director of Licensing, Mr. Abdullaev, to discuss the results with him. RA Hawkins emphasized that the review was performed on the basis of current practice and not on whether the CBU had effective laws and regulations in the area of bank supervision (i.e. procedure). RA Hawkins suggested that Mr. Abdullaev request a staff member to perform an evaluation to see which of the current CBU Policies and Procedures were not being adhered to by the BSD. Mr. Abdullaev agreed to this recommendation.


Bank Reporting. In November 2000, the CBU, for the first time, fined three banks for not reporting Allowances for Loan Losses correctly. This is a distinct change from the past.

### **PHASE III – APRIL 2001 THROUGH JULY 2001**

#### **A. The resident advisor will continue assistance to the CBU in the development of the On-Site Inspection program**

During this phase, RA Hawkins participated in several inspection processes, including:

- In April 2001, on-the-job training was provided to complete one inspection and to commence another inspection. The analysis that was performed at the bank inspection that was completed was an improvement from the past. Specific assistance was provided to the inspectors on defining affiliated parties under the current regulation, reviewing bank policies for adequacy,

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analyzing finance leases for proper underwriting, and analyzing earnings. General assistance was provided in the credit area as well. Assistance was also provided to the EIC on organizing and managing the inspection and the role that the EIC must play at each bank.

- In May 2001, RA Hawkins began assistance with another on-site inspection, focusing on asset classification, analysis of the bank's borrowers, and the establishment of general reserves on a loan portfolio that was acquired during a merger. The inspectors continued to have some problems identifying deficiencies in the area of management and asking for corrective action.
- In July 2001, on-the-job training was provided at an inspection that commenced during the month.


In addition to on-the-job training, RA Hawkins provided formal workshops, including:

- Formal training was provided to the on-site staff. A one-half day workshop was held for the On-Site Department at the end of the inspection to review the quality of the report. There were several items in the draft report that were unclear and the group was instrumental in identifying all of the problems in the report writing. As implemented previously that year, these workshops were held after the inspection report was completed in draft form so that there was time to allow for any additions, deletions, or other changes that were necessary. Compared to reports that were completed as late as the end of 2000, the current reports showed significant improvements.
- A four-day seminar was provided to the on-site inspection team to provide "lessons learned" from previous inspection, to provide each inspection with a personalized inspection manual, to provide an overview of the on-site manuals and to explain the purpose and usage of the manual. Although a few manuals had been provided previously to the inspection staff, there was little use of these manuals by the individuals at the inspections. The expectation in providing these manuals was that with individual ownership of the manuals, the inspectors would be more likely to read them, make notes in them, and use them. Many of the inspectors expressed that they were very pleased to have their own manuals and RA Hawkins noted that many staff members were reading them when not working in a bank. This was expected to help with the overall level of expertise within the department, the organization of inspections, and was expected to improve the report writing as well.
- Specific training was provided to the participants regarding the need for sufficient working papers.
- A one-half day workshop was held to review the inspection report from a bank inspection that was completed in May. The report writing still had some discrepancies, although a limited quality control by CBU has been performed already. This indicated that not only were there still problems in the report writing itself, but in the amount of quality control that is exhibited by the BSD prior to finalizing inspection reports.
- Two workshops were held with the inspection staff discussing non-accrual assets and liquidity.

**B. The resident advisor will provide assistance to the CBU in the further development of the off-site supervision program**

RA Hawkins delivered a one-week training workshop in April for the new members of Off-Site Supervision. The workshop was repeated during an additional one-week period in May for the Off-Site staff members from the regions. This workshop was provided at the request of the CBU and based on the success of the earlier workshop. The CBU had, at the time, developed off-site departments in the various regions, decentralizing some functions. This training was needed to help them become familiar with off-site analysis techniques. This workshop focused on the following areas:

- Instructions on Completing the Bank Call Report
- Purpose of Off-Site Supervision

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- Ratio Analysis
- Using the Bank Performance Report as an Analysis Tool
- Reporting Analysis Results
- Proper Corrective Action to be taken when Problems are Noted.
- Documentation of Analysis

In June 2001, a discussion was held with the Deputy Director on whether the CBU should provide Bank Performance Reports to the individual banks. RA Hawkins suggested that the CBU would need to provide a caveat that it was not completely assured of the accuracy of the data presented in the reports. RA Hawkins believed that this was necessary due to the fact that the CBU did not always require banks to make audit adjustments or to book adequate reserves. Thus, the capital and net income presented in the reports, and the ratios calculated from these items, would not always be correct and could be misleading.

**C. The resident advisor will assist the CBU in the review, development, and implementation of regulations**

In July 2001, the On-Site Examination Procedures Regulation needed to be signed by the Director of the BSD prior to presenting to the CBU Council. The Chief Attorney for the On-Site department indicated that the Director was reluctant to sign it because it did not require that the commercial bank management review and sign the report prior to finalization and internal review by the CBU. This practice, which had been in practice for several years, had resulted in the on-site staff not being held fully accountable for their reports. Inspection staff members would rationalize that once bank management signed the report, usually at the end of the inspection and prior to review by CBU, their own responsibility for any errors was eliminated. In short, part of the reason the process was not working well was because the inspectors had little or no real accountability for the quality of their work. This rationale and the resulting low quality work is why RA Hawkins recommended that this practice be eliminated from the draft regulation. RA Hawkins discussed the rationale with the Director who indicated that he fully understood why this regulation was needed and would present it to the CBU Council in the near future with the changes.


**D. The resident advisor will provide guidance on problem bank supervision techniques and the implementation of the procedures that were approved by the CBU Council in 1999**

Throughout this period of time, no assistance was requested in the area of problem banks by the CBU and RA Hawkins provided little direct assistance in this area. Based on his experience with the CBU, he noted that they were usually reluctant to acknowledge problems at banks and to certify certain banks as problems. RA Hawkins did provide templates to the CBU to use for developing enforcement agreements to use against banks. These templates provided information as to how to structure the agreements from both a legal standpoint and a regulatory standpoint.

**E. Other items relevant to the project**

Training courses. In April 2001, RA Hawkins provided a workshop to the students at the Bankers' Academy on corporate governance in banks. A discussion was held utilizing OSCE's Guidelines for Corporate Governance, followed by a detailed discussion of the Uzbek Corporate Governance regulation.

In May 2001, RA Hawkins completed his workshop for the students at the Bankers' Academy by providing a one-day seminar on bank supervision. This was a good forum for petitioning the need for banking reform. The Dean of the Banker's Academy requested that RA Hawkins provide an additional

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presentation at another workshop - RA Hawkins delivered a presentation on the Importance of Bank Regulator Independence for Ensuring Effective Banking Supervision.

CBU leadership changes. In June 2001, many changes were made with the management of the CBU. First Vice Chairman Jumaev was reassigned to Pakhta Bank, and he was replaced by the former Vice Chairman responsible for accounting, Mr. Djumageldiev. The Vice Chairman responsible for the BSD was replaced with Mr. Guliamov, who worked previously with President Karimov's office.

In July 2001, a meeting was held with the new Vice Chairman, Mr. Guliamov, to discuss the program, its successes and areas needing improvement. Previous correspondence to the former Vice Chairmen, a Bank Performance Report, and a Call Report were provided to him. The second meeting, which was held August 1, focused more specifically on what areas needed improvement if the programs established by the Barents/ USAID project were to continue without any deterioration after the USAID project closure.

Currency convertibility. In June 2001, President Islam Karimov signed a number of government resolutions to further liberalize the currency market and strengthen the monetary system within the republic. Although full convertibility would still not be allowed in Uzbekistan, this was considered a positive step. With the aim of encouraging the development of small and medium-sized enterprises and private businesses, and expanding their economic activities abroad, the resolution provided, from July 1, 2001, for releasing mini-farms and small and medium-sized enterprises from the obligatory sale of currency earnings received from the export of their own goods, work and services. It permitted the enterprises of small and medium-sized businesses to carry out exports of their own goods, work and services for foreign currency in cash, through the cash departments of banking institutions, entering currency earnings in their accounts in accordance with the set procedure. Also from that time, foreign companies and firms were granted the exclusive right to buy with freely convertible currency some kinds of high-liquidity output in guaranteed amounts. A free exchange rate for buying and selling foreign currencies in a number of operations on the off-exchange market, in accordance with supply and demand was allowed. The resolution also stated that after July 1, 2001 enterprises buying foreign currency at the free exchange rate on the off-exchange currency market would not have to pay a 5-per-cent commission for buying freely convertible currency.

In August 2001, Barents/ USAID assistance in the area of bank supervision by RA Hawkins ended. Various plans were explored on what kind of additional assistance is to be brought back to the CBU. As a result, central bank accounting was identified as an area of additional assistance (see next Phase below).

## **PHASE IV – SEPTEMBER 2001 THROUGH JANUARY 2002**

### **Background**


In September 2001, RA Raymond Mino was deployed to Tashkent to build upon technical assistance provided by previous USAID and World Bank advisors. A significant part of the advisors' activities was helping the CBU develop and implement accounting instructions consistent with International Accounting Standards (IAS). However, since the development and administration of accounting regulations is not a centralized process (a selection of ten regulations suggested by the CBU for review are housed in 3 different units), many of the existing regulations and instructions are inconsistent with other accounting regulations and instructions, and with IAS. During the 3rd and 4th quarter of 2000, USAID advisors, working closely with a Financial Sector Development Agency (FSDA) advisor and the former chief accountant of a large commercial bank, developed a comprehensive regulation and schedule for reconciling commercial banks' financial accounting income with their taxable income. At the same time, another USAID advisor was assisting the CBU in its efforts to ensure that the commercial banks made

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timely postings of the adjustments resulting from the external audits of 1999 results. Commercial banks reported that they could not post many adjustments because of conflicts with tax legislation.

RA Mino focused his assistance in the following two areas:



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- A. Assist in the development/establishment of an Accounting Methodology Department at the CBU, and make recommendations as to where to locate this department within the CBU. The Department will serve as the final authority on accounting issues at commercial banks. This centralized department will be responsible for both reviewing/modifying current accounting regulations and developing accounting regulations for use in commercial banks. Assistance will be required in both these areas. Review and development should focus on the elimination/clarification of regulations that are inconsistent with each other and with IAS**

Progress was achieved quickly on centralization of accounting methodology. Although there were initial signs of rivalry among three groups of accounting pronouncement issuers, the First Deputy Chairman made a quick decision that the unit should be based in the CBU Accounting Department under the direction of the existing Accounting Methodology Division. Several meetings with the head of this division were held and this person helped in compiling the list of current accounting regulations. He agrees that all accounting policies on a single subject should be aggregated according to the numbering scheme proposed by the FSDA accounting advisor.


A list from several sources, including the CBU Licensing and Accounting Departments, the PRAVO national legislative and normative database and FSDA, was compiled and presented to the director of the Accounting Methodology Division. The final list shows seven different groups within the CBU that have been issuing accounting policies.

Work on CBU instruction 363 on Foreign Exchange assumed urgency with the decision by the government to merge two exchange rates. The previous "Central Bank Rate", which commercial banks were directed to use to revalue their foreign exchange position, was morphed into the "commercial or off-exchange rate" (supposedly derived from inter-bank trading). RA Mino participated in a fact-finding seminar organized by the CBU to determine the immediate effects of this surprise move on commercial banks. It seems that any bank with a net liability position in foreign exchange could experience large losses because of this change. On the other hand, banks with a net asset position in foreign exchange will have large unrealized gains, but no cash to pay tax on them. Intertwined in all this are the large balances that banks that sold shares for dollars have in a special kind of capital account authorized by the current regulation.

The FSDA advisor did some basic work on the new regulation and RA Mino, together with the head of the Accounting Methodology Division, completed a thorough rewrite of the current rule, which was extensively revised to follow IAS 21 in "form and content". An appendix was attached including a rewrite of the examples from the original instruction. Using the database of regulations affecting commercial banks developed previously, other regulations containing accounting examples related to foreign exchange transactions were located. These examples were reviewed, revised and added to the appendix of the new draft regulation.

At the end of December 2001, the CBU Chief Accountant provided the draft regulation for review. The quality of this new regulation was poor as the CBU merely revised the previous regulation, rather than moving more closely towards IAS. There was one major change; the previous provision for foreign exchange gains and losses to be taken directly to equity was removed and replaced with the IAS benchmark treatment of recognition in period income. This was followed, however, by the arbitrary removal of the word "severe", when referring to currency devaluation that qualified for the allowed alternative treatment.

RA Mino reviewed and edited CBU Rule 61, which is being reissued by the Accounting Methodology Group. The rule, entitled "On policy for accounting and reporting in commercial banks of the Republic of

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Uzbekistan”, reverts to the compliance-based system of the former Soviet Union, when every aspect of banks’ operations were strictly controlled. The rule, although softened through amendments, remains overly intrusive. Written recommendations were provided to the Accounting Methodology Group. In general, it was recommended that the current CBU rule on internal control, developed with USAID assistance, be amended to include any parts of Rule 61 deemed necessary and that Rule 61 be abandoned. By mid-January, despite numerous requests, the Chief Accountant had not responded to RA Mino’s comments on this rule.

After a request by the head of the Methodology Department of the CBU, RA Mino prepared and delivered a speech to a conference on “Problems of Improvement of Tax Legislation”. Special issues regarding bank taxation, such as legislative recognition of IAS, taxation of banks on a consolidated basis, recognition of the accrual principal for banks, recognition of banks provision for possible loan and other losses, and the ability to file an amended return after an audit were discussed. Following RA Mino’s speech, the head of the Methodology Department of the CBU spoke and said that it was “still too early” in the “crisis” to use the accrual method of accounting.

**Recommendation:** The CBU lacks a critical mass of individuals adequately trained in the accounting profession. Although the issuance of accounting pronouncements is now centralized in the Accounting Methodology Department under the Chief Accountant, the members of this group need a thorough grounding in accounting. RA Mino drafted a letter to the CBU Deputy Chairman for Supervision stressing the importance of formal accounting training for selected CBU staff, enclosing information on the USAID SME program for certifying Russian speaking accountants and suggesting ten individuals, five from the supervision department and five from the accounting methodology department.


It is recommended that any further accounting assistance to the CBU should be postponed until these ten individuals have attained certification as “Certified Accounting Practitioner (CAP)” by the International Council of Certified Accountants and Auditors (ICCAA).

## **B. Secure adoption of the comprehensive new tax regulation, containing the reconciliation form and instructions for calculating income taxes**

During this phase, RA Mino assisted with gathering support within CBU and State Tax Committee to implement tax reconciliation form. While he was instrumental to enhance the dialogue on this issue, the successful implementation of the tax reconciliation form did not take place during RA Mino’s assistance. By the end of RA Mino’s assignment, USAID also decided to scale back all assistance due to weak progress in the economic reform by the Government. Below we outline some of RA Mino’s efforts in the area of tax reconciliation.

At a RA Mino’s meeting with the CBU First Deputy Chairman, he expressed his full support for rapid implementation to the tax reconciliation form. The newly appointed CBU Deputy Chairman for Supervision, who claimed that it was the top item on his agenda, echoed his sentiments. His subordinate, the CBU Director of Licensing, stated in another meeting that he and his boss would personally bring the proposal to the CBU Chairman, urge that he call the State Tax Committee Deputy Chairman to his office, and secure his approval. The CBU appears to be clearly in favor of not only the concept, but also the current draft.

A number of meetings with the Deputy Chairman of a large commercial bank were held. This individual was seconded to the FSDA during the last quarter of 2000 and was one of the primary developers of the tax reconciliation form and procedure. The unanimous opinion was that, given the reluctance of the State Tax Committee to make any changes to the status quo, the absence of foreign advisors urging the CBU to press for this reform was the primary reason why it was not adopted. In a separate meeting, the CBU

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Chief Accountant said that he sent a letter urging action on the matter to the State Tax Committee in early July, but received no response. Subsequently, a copy of the State Tax Committee's response to the CBU, dated August 7, 2001 was obtained.

The most recent draft of the tax reconciliation measure was obtained and reviewed. Apart from some minor revisions made at the behest of the CBU's former First Deputy Chairman, it is identical to the version prepared by USAID advisors during 2000. Some examples from CPE material "Understanding Schedules M1 and M2" were translated and provided to the CBU. It seemed to have addressed all of the expressed concerns of the State Tax Committee.

On November 9, the CBU Licensing Department sent the proposed tax reconciliation form and regulation to the CBU's 17 member "expert committee" for their endorsement. Earlier, the Director of the Licensing Department said he would go to the CBU Chairman, make his arguments in favor of the measure, and urge the chairman to call the chairman of the Tax Committee and secure his approval. Apparently, he decided to go via the expert committee, as it would give him more clout when he brought it to the CBU chairman. Subsequently, plans were changed again and it was decided to bring the document before the CBU board for formal adoption.

On November 12, RA Mino wrote individual letters to the expert committee members asking them to speed the process along. On November 14, RA Mino received a letter from the CBU chief accountant informing that the draft form and regulation "have been already agreed with the Ministry of Finance" and has been sent to the Tax Committee Deputy Chairman for his signature.

By November 23, all members of the CBU's expert committee had approved the measure and on that day it was formally sent to the Tax Committee for circulation to its own "expert committee". At this time it was decided by the CBU that approval by the Tax Committee's experts would be a prerequisite to bring the resolution before the CBU board. A delegation from the CBU visited the Tax Committee to lobby for acceptance during the week of November 26.


By the end of the November, it was decided to bring the measure before the CBU board with or without the Tax Committee's approval. Shortly after, the CBU reneged on its decision to bring the tax reconciliation measure before the CBU board with or without the Tax Committee's approval.

On December 11, a letter was received from the head of the Department of Perfection of Methodology of Taxation of the State Tax Committee outlining his objections to some language in the document. He identified twenty-two paragraphs of current tax legislation that were not, in his opinion, addressed in the tax reconciliation regulation. In addition, he had some objections to some of the language in the regulation.

In late December, the CBU was waiting for a response to the State Tax Committee's original letter from a Deputy Chairman of a large commercial bank, who is involved in this process. As of the end of December, such response was unavailable.

In early January, RA Mino met again with the CBU Deputy Chairman for Supervision to discuss progress on the measure. At that time he indicated that there "was some movement" on adoption of the regulation and said he had prepared a letter that would form the CBU's official response to the State Tax Committee's letter of December 11.

**Recommendation:** Commercial banks are prohibited from implementing International Accounting Standards and CBU accounting instructions because they conflict with the rules for tax accounting. RA

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Mino recommended that the CBU secure enactment and acceptance of a tax reconciliation form before any assistance is continued.

## **PHASE V – AUGUST 2002**

While USAID/ Barents assistance technically ended in January 2002, after it was determined that more progress on economic reform was necessary if assistance were to continue, some limited assistance was again provided during August 2002.

### **A. Conduct a training course at the Central Bank of Uzbekistan on foreign exchange risk in banking operations**


RA Bryan Stirewalt (from Kazakhstan component of this Task Order) devoted his time during the first two weeks of August 2002 to developing and delivering a training course on foreign exchange risk and trading operations for CBU staff. The course provided an overview of risk management in general, with a more detailed focus on foreign exchange risk. The course addressed front office inspection issues and internal controls, back office inspection issues and internal controls, various products used in management of foreign exchange risk, a discussion of the 1996 market risk addition to the Basle Committee Capital Accord - emphasizing foreign exchange risk, sample regulations governing foreign exchange risk in other countries, and brief discussions of current events in global currency markets. Also discussed were the problems with dealing operations at Barings Bank and with Allied Irish Bank.

The course was delivered to 20 participants, mostly from banking supervision. A group of 4-6 persons from the monetary policy area of the CBU were also in attendance. The persons from monetary policy asked most of the questions and were the most interactive. RA Stirewalt also met with Deputy Governor Gulyamov before the training session began to discuss developments in Uzbekistan. In addition, RA Stirewalt met with other persons outside the CBU to discuss their views of currency operations and markets in Uzbekistan. Uzbekistan is a unique country regarding foreign exchange risk issues, as the Government controls the official currency exchange rates. Therefore, banks have very small open positions in foreign currencies and do not perform any real trading operations. The Government plans to open currency markets in the upcoming months, and requested this course to prepare inspectors for analysis of policies, procedures and controls related to foreign exchange risk and currency trading operations.

Unanimously, people at the CBU are confident that currency convertibility and compliance with IMF Article 8 are on schedule for completion before the end of 2002. The private sector is much more skeptical. The Government of Uzbekistan has loosened the official exchange rate; however, they also applied extreme pressure (police presence and threats) on the black market to bring market rates closer to the official rate. The existing structure damages trade and trust in the financial sector as a whole. From hearsay, many State-owned companies have borrowings in US Dollars without significant US Dollar receipts. As the official exchange rate devalues, the FX borrowings become increasingly more expensive. The Government slowed progress toward convertibility when some of these companies expressed their concerns or opposition.

## **III. PROJECT ACTIVITY WITH USAID AND USAID PARTNERS**

During the course of the project, RA Hawkins regularly participated in relevant USAID meetings, and was pro-active in providing support to other USAID partners. Some of the areas of cooperation include:

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- In March 2000, the project provided translated copies of the new Decrees and Resolutions to USAID for distribution to other projects as needed.
- In May 2000, a meeting was also held with a representative of the USAID Trade and Investment Project to discuss providing information to that project for a final report.
- In July and August 2000, meetings were held between RA Hawkins and Susan Thetford to discuss the accounting assistance that was provided to the CBU by USAID/IBTCI in the fall 2000.
- In October 2000, a meeting was held with Jim Goggin, USAID Country Representative, to discuss the successes of the project and the areas needing improvement. Mr. Goggin was interested in keeping informed about the project on an on-going basis. A meeting was also held with Barbara Cates of the United States Embassy to discuss the project.
- In November 2000, a meeting was held with the representative of the USAID project (SME project) being implemented by Pragma Corporation.
- In January 2001, a meeting was held with the United States Ambassador to Uzbekistan, John Herbst. USAID representatives attended with RA Hawkins. The Ambassador was very interested in the project and in the impediments to further success.

#### **IV. PROJECT ACTIVITY WITH OTHER DONOR ORGANIZATIONS**

Similarly, RA Hawkins cooperated with other donor agencies in numerous occasions, including:

- In March 2000, RA Hawkins attended a meeting of an American Chamber of Commerce committee dedicated to improving the access to funds in banks by commercial enterprises in Uzbekistan.
- In April 2000, RA Hawkins met with Michael Crossley of Arthur Andersen, contractor for the World Bank project on several occasions. Translations of pertinent regulations were provided to him and information on several banks was provided.
- In May 2000, a meeting was held with a consultant working on an ADB project. This project would help establish Credit Unions in Uzbekistan and the main task for this consultant was to help refine and pass a Credit Union law. Regular discussions were held between RA Hawkins and the ADB consultant working to establish credit unions in Uzbekistan.
- In April 2001, RA Hawkins was asked to review training materials provided by a consultant from the World Bank project. Most of the changes that were needed were due to specific regulatory requirements for banks in Uzbekistan.
- In May 2001, financial information for five banks was provided to the consultants of the World Bank. Discussions were held with the accountants from this project as needed.
- In June 2001, discussions were held with some consultants from the World Bank (FSDA) project. The discussions centered on the type of information that should be required by a bank prior to placing a deposit with another local bank.
- In July 2001, RA Hawkins was contacted by an ADB contractor who requested general information about the fiscal and monetary reform in Uzbekistan.

#### **V. OBSTACLES TO SUCCESSFUL COMPLETION OF TARGETS**

We did not encounter any significant obstacles to the successful completion of this Project. All tangible results and benchmarks have been achieved. The largest impediments to the successful of this Project was the lack of political will on the part of the Government of Uzbekistan (not necessarily the Central Bank of Uzbekistan alone) for positive change. Uzbekistan remains a closed economy. Major reforms will only take place after the Government makes a market economy a formal goal. Within banking

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supervision, several problematic areas remain. Although RA Hawkins and RA Mino and the previous Resident Advisors had discussed these problems with CBU management, the CBU had been either unwilling or unable to make a management change in this department. RA Hawkins recommended that any future USAID assistance in this area should require that the CBU install adequate management in the department in order to maximize the ability of the program to succeed.